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Art as Collateral

May 25, 2010
New York, New York





Consignment

Black's Law Dictionary: "...to send or transmit goods to a merchant, factor or agent for sale"



Art Industry Practices

- Consignments are pervasive in the art world
 - Consignments by collectors to dealers
 - Consignments by dealers to other dealers
 - Consignments by artists to dealers
 - Participations between consignors and consignees



What is a Consignment?

- UCC Article 9 (key elements): (i) consignee is not an auctioneer; (ii) artwork is not consumer goods immediately prior to consignment; (iii) consignee is not generally known to deal substantially in goods of others
 - If you meet the test, Article 9 provides procedure for consignor to protect itself. The problem is that most art consignments will not be eligible for this protection.
 - Consignor must file a UCC and send notice to previously filed secured creditors of the consignee
 - Goal is to protect creditors of merchants from being deceived as to what is their inventory collateral



Risks to Private Banks

- Transaction somehow deemed to be an Article 9 consignment and consignor/collector has not filed, sent notice, etc.:
 - Collector client may lose its artwork to the gallery's creditors in a gallery insolvency
 - Collector's private bank may lose to the gallery's creditors as well



Risks to Private Banks (cont.)

- If consignment is found not to be governed by Article 9
 - Gallery's creditors may still prevail under the UCC "sale or return" provisions of Section 2-326
 - More likely, the issue of priority would be resolved under the law of bailments
 - Under bailment law, the collector (and its private bank), if it can prove its ownership, would win...eventually



Risks to Private Banks (cont.)

- Possession is the best kind of protection for lender
 - At least monitor the location of collateral
 - Require a prescribed form of bailment or consignment agreement be used by collector clients, ideally with the bank made a party
 - Unequivocal evidence of ownership by collector will prevent many of the Salander problems.



Risks to Private Banks (cont.)

- Possible loss of security interest in art collateral if sold by consignee to an ordinary course buyer
 - Uncertain as a legal matter, but private bank's security interest in the art work may be extinguished on a sale by a consignee/dealer to a non-dealer/collector, in an ordinary course sale
 - Again, if possession is not an option, monitoring of your collateral is the best protection



Risks to Middle-Market Lenders to Galleries / Dealers

- Inventory collateral may not be what it appears to be
 - Hidden “trust fund” interests of artists
- An artist need not file or do anything to protect its rights to this “trust fund”
- A dealer’s inventory may, in fact, belong to collectors or to other dealers
- Your dealer/borrower’s inventory may be consigned to another dealer, whose creditors may have good claims
- Regular reporting, with detailed information about all gallery inventory, is advisable
- Borrowing base loans should make all consigned inventory, and inventory subject to participations, ineligible



Risks to Middle-Market Lenders to Galleries / Dealers (cont.)

- Are “trust funds” being diverted by lenders receiving payments of debt service from dealers?
 - Lenders to galleries that represent a lot of artists, should require regular reporting of sales of original art work and of payments over to artist/consignors
- Gallery’s cash position may not be what it appears to be, if money is owing to a collector, an artist or to another dealer, and paperwork or financial reporting is lacking



Art Industry Norms Pose a Problem for All Art Lenders

- The absence of good paperwork exacerbates the problems posed by consignments
- Secured lenders usually can rely on UCC Article 9, but it does not work well in the art world
 - Protections afforded a consignor are not likely to be available for art and even where they would work, the procedure is likely to be ignored

Basic Advice to All Art Lenders

- Lenders, taking art as collateral, should not be afraid to encourage better, more businesslike, practices among its collector and dealer clientele

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The Intersection of Art and Bankruptcy



May 25, 2010

New York, New York



Salander-O'Reilly Galleries, LLC

- Salander-O'Reilly Galleries faced extensive litigation over claims that it had misapplied artwork and misapplied proceeds of sales
 - Gallery assets frozen
 - Gallery appointed Joe Sarachek to act as chief restructuring officer



An Intricate Mess

- When chapter 11 case commenced, Gallery held thousands of artworks
 - Items owned by Gallery
 - Items Salander claimed to own
 - Consigned items
 - Artist items
 - Participation interest items
- What was property of the estate?
- DIP financing issues



An Intricate Mess (cont.)

- New York District Attorney opened criminal investigation into Salander and Gallery, and seized Gallery's records
 - Salander pleaded guilty to 16 counts of larceny and other crimes in March and faces 6-18 years
- Seizure made resolution of ownership claims more difficult



An Uncertain Resolution

- To resolve ownership claims, protocol was established to handle issues internally
 - Joe Sarachek and Creditors Committee participated with claimants
 - Forum permitted relaxed forms of proof of ownership or consignment
 - Many consignors had not complied with New York UCC provisions
 - Poorly drafted sale and participation agreements
 - New York Arts and Cultural Affairs Law issues



Pennies on the Dollar

- Gallery ordered to pay \$120 million in restitution
 - Full payment unlikely
- Furniture, rugs and other works sold recently at Stair Galleries
- Christie's will sell 130 lots on June 9
 - Many items expected to sell at prices below Gallery's acquisition cost
 - Title insurance will be available



Lessons Learned

- Case illustrates the importance of documenting transactions clearly in accordance with law
 - Similar issues arose in Crispo and Berry-Hill cases
 - Those who fail to learn from mistakes of history repeat them
- Lenders and art owners will face Salander issues if they fail to document their transactions properly

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