

# ART & ADVOCACY



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## Pending Bill Could Revive the Practice of Fractional Giving

*By Eli Akhavan and Michael Kessel*

Prior to the passing of the Pension Protection Act of 2006, donors could take charitable deductions for the donation of fractional interests in their artwork. The fractional donation rules allowed a donor to donate small stakes in its artwork to a museum over time and receive increasingly larger deductions on the portions to be donated each year if the donated artwork appreciated in value. The donor could continue to take advantage of this until he or she gave away the entire interest in the artwork, and could take as many years as he or she desired to do so.

For example, if a donor donated a 10% interest in a \$10,000 painting, the donor would be entitled to a \$1,000 charitable contribution deduction. If the donor donated another 10% interest in the painting in a later year, and the \$10,000 painting had appreciated to \$20,000 at the time of the later fractional donation, the deduction would be \$2,000. (Similarly, if the donated art depreciated in value from its initial \$10,000 valuation, the next fractional interest deduction would be based on that lower fair market value.)

In addition to the tax benefit, and depending upon the negotiated deal with the donee museum, the fractional donation strategy provided a donor the advantage of maintaining possession of the artwork. When all fractional portions of the gift were donated, the museum would take possession. The Act changed those rules.

The Act restricted prohibited donors of fractional interests in art from realizing tax benefits on the appreciation of the art's value and limited the time allotted to complete the donation to 10 years (or the time of the donor's death, whichever occurs first). For example, using the fact pattern set forth above, the art collector's deduction in year two would be limited to the lower of (i) the fair market value of the property as of the time of the initial donation multiplied by the fractional portion of the property donated in year two (\$1,000); or (ii) the fair market value

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of the fractional portion of the property at the time of the additional contribution (\$2,000). Additionally, the charity had to have substantial physical possession of the property.

Since the passage of the Act, wealth advisers have discouraged their clients from making fractional contributions in works of art which has, in turn, reduced the number of gifts to museums. However, art collectors may soon have an added incentive to make fractional gifts of artwork to museums. On August 6, 2009, New York Senator Charles Schumer introduced a bill (S. 1605) that could revive the practice of fractional giving by simplifying the process and offering greater tax benefits.

The bill would once again permit donors to claim an increased deduction for future fractional donations of artwork based upon the fair market value of the subsequent gifts of fractional interests at the time they are donated and extend the period for making these donations to 20 years from the current 10 years.

#### Specifics of the Proposed Bill

As proposed, the new law would require that a taxpayer who desires to make a fractional donation must: (1) make an initial fractional contribution of at least 10% of the artwork; and (2) enter into a written contract with the donee which would require the donor (i) to contribute at least 20% of the artwork within 11 years of the initial fractional contribution; and (ii) to contribute all interests in the property on the earlier of the donor's death or

within 20 years of the initial fractional contribution. It is important for taxpayers to note that if the art declines in value, the same rules apply and the donor's tax benefits could shrink.

New requirements would also include that over each five year period commencing with the date of the initial fractional interest, the donee museum be in actual physical possession of the property for a portion of the time "substantially" equivalent to its fractional interest. For example, a museum with a 10% interest in a painting must take physical possession of the painting for six months over a five year period.

Additionally, taxpayers making fractional gifts of an artwork with a fair market value of greater than \$1 million must obtain a statement of value from the IRS and attach it to their tax returns. The procedure of this new requirement will likely be similar to the current voluntary statement of value process that is available for taxpayers under which taxpayers can submit appraisals to the IRS to have the IRS substantiate the value of artwork for income, estate and gift tax purposes.

#### Our Recommendation

The bill is currently pending and it is unclear as to when and if it will be passed into law. However, if you're currently contemplating making fractional gifts of art, we advise waiting until the status of the Schumer bill is determined as it greatly eases the current restrictions on fractional donations.

## So, You Bought a Fake? Now What?

By Mari-Claudia Jiménez

Imagine this: You buy what you believe to be an authentic Claude Monet painting from a reputable art dealer. It hangs in your living room for 15 years until one day you decide that you want to sell it. In connection with a possible sale you have the painting appraised by the world's foremost expert on Claude Monet, who unceremoniously tells you that the painting is a fake. So, what do you do now?

Though the time in which to take action is limited by the statute of limitations, a buyer of a counterfeit artwork has a number of possible remedies against the seller of that artwork.

#### Fraud

A buyer may bring a tort action for fraud against the seller for monetary damages or a rescission of the transaction. To establish fraud, a buyer generally must prove that: (1) the seller made a misstatement related to a material issue of fact; (2) such misstatement was made deceitfully with intent to induce reliance; (3) such misstatement did, in fact, induce justifiable reliance; and (4) as a result the buyer suffered damages. In New York, where the seller knowingly commits a fraud by selling an artwork it knows to be counterfeit, the statute of limitations on fraud claims is either six years from the date of the fraud (which in these cases would be the date of purchase of the counterfeit artwork) or two years from the date the fraud was discovered, or with reasonable diligence, could have been discovered by the buyer. See N.Y. C.P.L.R. §213(1), §213(8), §203(g).

A buyer may also have an action for fraud, even if the misrepresentation was merely negligent, if the seller failed to exercise reasonable skill or care in ascertaining the authorship of the artwork or — if the seller is a dealer, art gallery or auction house — failed to exercise the skill and competence required by its profession.

Traditionally, damages for fraud are limited to the buyer's out-of-pocket expense at the time of the original sale (i.e., the price paid for the counterfeit artwork) plus interest. However, in a recent New York Supreme Court case, *Tony Shafrazi Gallery Inc. v. Christie's Inc.*, 2009 N.Y. Misc. LEXIS 2428 (2009), the court found that the potential

remedies available for fraud also include not only consequential damages, but all remedies available for non-fraudulent breach. Thus, the buyer was able to pursue the recovery of the current fair market value of the painting had it been authentic. This "benefit of the bargain" approach puts the buyer in the same position he would have been in had the artwork not been counterfeit. The court even sustained a claim for punitive damages.

#### Misrepresentation

Under contract law, a buyer may also bring an action for misrepresentation to rescind the contract with the seller. A misrepresentation may make a contract voidable if the buyer can prove that the misrepresentation was material or intended to deceive. Since the authorship of artwork is always material to a sale, a buyer usually doesn't need to prove that the seller intended to deceive. However, if the buyer did not exercise his own independent judgment with regard to the authorship of the artwork, it would be difficult to rescind a contract for misrepresentation based on materiality unless a special relationship existed between the buyer and the seller, or the buyer reasonably believed that the seller possessed a special skill or expertise with regard to the artwork.

#### Mutual Mistake

A buyer can also seek rescission of the contract under the doctrine of mutual mistake. In such a case the buyer must show that: (1) the mistake was a basic assumption on which the contract was made; (2) the mistake had a material effect on the agreed-upon exchange of performances between the parties; and (3) the buyer did not assume the risk of the mistake. In a case where the seller did not intend to deceive the buyer, the seller can defend himself by claiming that the buyer assumed the risk of lack of authenticity. In *Weisz v. Parke-Bernet Galleries, Inc.*, 67 Misc. 2d 1077 (N.Y. Sup. App. Term 1974), the plaintiffs sued the gallery after discovering that two Raoul Dufy paintings they had purchased at auction with the belief that they were authentic were, in fact, forgeries. The court refused to rescind the contract, finding that there was no evidence of willful intent to deceive and the purchasers assumed the risk that the paintings could be counterfeit.

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According to Uniform Commercial Code §§2-725(1) and (2) “an action for breach of any contract for sale must be commenced within four years after the cause of action has accrued,” and “[a] cause of action accrues when the breach occurs, regardless of the aggrieved party’s lack of knowledge of the breach.” Therefore, the buyer has only four years from the date of the sale to determine whether the purchased artwork is truly as described in the contract of sale with the seller. Since the cause of action occurs at the time of the breach (i.e., at the time of the misrepresentation or mutual mistake), the buyer must act quickly to ensure that the artwork is authentic. If the buyer waits too long and the artwork is counterfeit, he may lose his chance to bring an action for breach of contract.

#### Breach of Warranty

Another alternative for buyers of counterfeit art is to bring an action for breach of warranty, either express or implied. A cause of action for breach of warranty must be brought within four years of the date the artwork is delivered. This course of action is particularly useful because the buyer need not prove any fault by the seller; the buyer need only prove that a warranty existed, the goods failed to conform to that warranty, and he suffered a loss

as a result. Also, unlike an action for misrepresentation or mutual mistake where the buyer’s remedy is limited to rescission of the contract, an action for breach of warranty allows a buyer to recover actual damages from the seller. A warranty action under U.C.C. §2-714(2) allows the buyer to recover the difference between the value of the defective artwork he received and the value of the artwork as it was warranted (i.e., the value of an authentic artwork), instead of merely rescinding the contract and recovering the out-of-pocket cost paid by the buyer for the artwork.

#### Express Warranties (U.C.C. §2-313)

The first type of warranty, an express warranty, arises from: (1) any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain, and (2) any description of the goods which is made part of the basis of the bargain (U.C.C. §2-313). An express warranty can arise from representations made in materials such as advertisements or catalogues, if the buyer can demonstrate that he had knowledge of the representation and the representation was the basis of the bargain with the seller. An express warranty can also arise from a seller’s oral statements to the buyer, though the buyer must be able to distinguish between representations of fact by the seller, which would create a warranty, and mere opinions or “puffing,” which would not.



{ Portrait of a Woman, 18th–19th centuries. Originally attributed to Goya, conservators took X-ray images of the painting in 1954 and found an earlier portrait beneath the surface. }

One difficulty of applying warranty law to sales of counterfeit or misattributed art is defining the meaning of the U.C.C. §2-313 phrase “any description of the goods which is made part of the basis of the bargain.” Outside of an art context this may be easy to do, as a description of the goods sold can generally be considered an express warranty. However, attributions of artwork can sometimes be imprecise. When an artwork is said to be by a particular artist, then there is no question that that attribution creates an express warranty. However, if an artwork is described as being “in the manner of” or “from the school of” a particular artist, then that statement does not constitute an express warranty.

#### Warranty of Merchantability (U.C.C. 2-314)

Auction houses and art galleries qualify as “merchants” within the U.C.C. definitions; as such, they are liable for the art they sell. Thus, a buyer may also bring an action

against a gallery, art dealer, or auction house for breach of an implied warranty of merchantability under U.C.C. §2-314. For the art to be merchantable, it must (1) be able to pass without objection in the trade under the contract description; (2) be fit for the ordinary purpose for which it is sold; and (3) conform to the description made in the sale catalog or the bill of sale. U.C.C. §2-314 provides that “unless excluded or modified... a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to the good of that kind.” Therefore, a buyer can rely on an implied warranty of merchantability when the goods sold by an art dealer or an auction house do not meet any one of the requirements of merchantability specified. A buyer may be able to claim a breach of implied warranty of merchantability if he can demonstrate that: (1) a work of art does not conform to its description; (2) his investment or aesthetic purposes are compromised because the work is a forgery; or (3) the signature on the work is equal to a promise or affirmation of fact.

Some states have enacted laws specifically addressing art warranties. Under N.Y. Arts & Cult. Aff. Law §§ 13.01-13.21, any art merchant that sells an artwork to a non-merchant buyer creates an express warranty if, in its written description of the artwork, the merchant identifies the artwork with a particular author or authorship. According to this law, statements as to the authenticity of a work become the basis of the bargain. The law does not tolerate “puffing” to induce the buyer to purchase a piece of art. To negate an express warranty of authenticity under this law, a disclaimer must be conspicuously written and contained in a separate provision from the language creating the warranty. The disclaimer must be written “in words which would clearly and specifically apprise the buyer that the seller assumes no risk, liability, or responsibility for authenticity of the authorship.” In order to protect the buyer, however, a disclaimer of express warranty will be ineffectual if it is later shown that the work of art was counterfeit.

#### Auction House Guarantees

In addition to the statutory warranties inherent in all contracts of sale under the U.C.C., auction houses often provide specific guarantees with regard to artworks they sell. Therefore, it is always important for a buyer to review the conditions of sale in the sales catalogues to see what guarantees are applicable to the artwork they are considering purchasing. Auction house guarantees tend to be limited, so it is essential to note the exact terms and duration of the applicable guarantee.

#### “Caveat Emptor”

In New York, an innocent buyer of counterfeit art who discovers his artwork is inauthentic after the four-year statute of limitations on contract and warranty claims expires may still be able to bring an action if he can successfully plead a claim for fraud on the part of the seller. Since the statute of limitations in a fraud claim is either six years from the date of the fraud (which in these cases would be the date of purchase of the counterfeit artwork), or two years from the date the fraud was discovered, or with reasonable diligence could have been discovered by the buyer, fraud is the only cause of action (other than an action based on a specific auction house guarantee, which may vary in duration) that could be brought if the buyer discovers his artwork is counterfeit more than four years after he bought it.

Given the difficulty in proving a fraud claim, art buyers should take affirmative steps to confirm that the artworks they are considering buying are authentic and merchantable before purchase. Buyers who have recently purchased art without confirming its authenticity and merchantability should take steps as soon as possible to do so. Unfortunately, given the short statutes of limitations for the remedies available, art buyers who simply hang their new purchases on the wall and do not discover that their artworks are counterfeit until decades later are often left without any remedy at all.

## Private Bank Art Loans The Risks of Non-Possessory Security Interests

By Stephen Brodie

Many private banks will make loans to their clients, and receive fine art as collateral. Generally speaking, however, private bankers are reluctant to require these clients to relinquish possession of their art collections. The private banking relationship usually has trust as its cornerstone, and taking a painting off a client's wall to put it in a bonded warehouse runs very much against the grain.

Although a lender can perfect a security interest by filing a U.C.C. financing statement and be just as protected from other creditors' claims as it would be had it perfected by taking possession, credit risks resulting from this accommodation by the lender are self-evident (e.g., loss of the collateral due to theft or casualty coupled with lapsed or inadequate insurance). But banks that make this accommodation also face a less obvious risk. For example, what would happen if a client sold art used as collateral without advising the bank? Would the bank's security interest (perfected by a properly filed U.C.C. financing statement) continue in the artwork after the sale? Is the buyer under a duty to investigate possible encumbrances on the seller's title, such as the bank's filed financing statement? The answers to these questions depend on certain additional facts.



The following three fact patterns illustrate some of the risks. For each, assume the following: A private bank ("PB") has a client ("C") who has an art collection. C pledges the art to PB to secure a loan. PB obtains a security agreement that prohibits sales of collateral without PB's consent, and files a U.C.C. financing statement identifying the artwork owned by C as PB's collateral. No prior liens exist, and PB does not take possession.

- 1 If C is merely a collector who takes a painting from his living room and sells it outright (i.e., not on consignment) to a friend ("F"), where F is also just a collector, then PB's security interest would continue in the painting after the sale, unless the sale takes place before the actual filing of PB's U.C.C. financing statement.
- 2 If C has been active as both a collector and trader or dealer involved in private sales (as is often the case), and F is merely a collector, there is a distinct possibility that the sale to F constitutes a sale "in the ordinary course of business" (just like buying a car from a car dealer), and that PB's security interest in the painting would be extinguished. (The security interest would continue in the "proceeds" of the sale, but that may well be cold comfort to PB.)
- 3 If C is both a collector and a dealer and sells to another dealer, or if F is both a collector and a dealer, PB's security interest will likely continue. Although the sale may well constitute an "ordinary course" transaction, the law imposes a duty on a buyer/dealer to find the filed U.C.C. financing statement and to then investigate the terms of the security agreement between PB and C (and thereby uncover the prohibition on the sale of collateral without PB's consent). This duty on the buyer/dealer protects PB from losing its security interest in the artwork.

Other than the risk a bank faces if it fails to promptly file a U.C.C. financing statement, the one clear risk evident in the foregoing fact patterns is that a sale by a client who the bank believes to be just a collector could turn out to be a sale by (what the law considers to be) an art dealer. The "ordinary course" sale rule is, among other things, intended to facilitate commerce by allowing the public to purchase inventory from a merchant without having to conduct lien searches and other due diligence. The language of the U.C.C. itself and certain cases decided thereunder make it clear that the question of whether a particular transfer is a "sale in the ordinary course" often depends on whether the seller is in the business of selling goods of the kind in question. The business of being an art dealer does not have to be the collector's primary business for the risk of the involuntary loss of a

security interest to arise. A private bank's concerns are exacerbated by today's common practice of collectors creating wholly owned limited liability companies or other such entities to buy and sell artwork, often in connection with tax-free exchanges under Section 1031 of the Internal Revenue Code. Such trading vehicles are far more likely to constitute dealers than are collectors who, from time to time, sell a painting or two.

The fact patterns presented are, of course, quite straightforward. In subsequent articles, we will examine consignment sales, auction sales, and other more complex scenarios, sometimes involving the creditors of a consignee or other dealer, all of which can bear upon the credit risk to a private bank that declines to require possession of art used as collateral.



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## Art Law Events

### Recent Events Involving Herrick's Art Law Department

*September 22, 2009*

Frank Lord was a panelist at the New York City Bar Association's Committee on Career Advancement and Management event entitled "How Another Degree in Addition to a JD Can Enhance One's Career."

*September 29, 2009*

Lawrence Kaye delivered the keynote address at the Basel Institute on Governance's conference on "Governance of Cultural Property: Preservation and Recovery" in Switzerland. For more information, visit [www.herrick.com/GovernanceConference](http://www.herrick.com/GovernanceConference).

*October 5-6, 2009*

Lawrence Kaye gave a series of lectures in connection with the opening of the Goudstikker Exhibition at The Marion Koogler McNay Art Museum in San Antonio, Texas. The exhibition will remain at the museum through January 20, 2010. For more information, visit [www.mcnayart.org](http://www.mcnayart.org).

*October 20, 2009*

Herrick sponsored an event for Tufts Hillel entitled "Rewriting History at Long Last: The Saga of the Goudstikker Art Collection From Nazi Looting to Restitution." Featured speakers included Jeffrey Summit, Neubauer Executive Director, from Tufts Hillel, and Lawrence Kaye, Howard Spiegler and Steven Feldman from Herrick.

*October 27-31, 2009*

Howard Spiegler and Charles Goldstein spoke at the annual Congress of the Union Internationale des Avocats (International Association of Lawyers) (UIA) in Seville, Spain. Howard spoke on legal issues involving modern art on a panel alongside Monica Dugot of Christie's, as well as other art lawyers from Italy, Belgium, Switzerland and Spain. Charles Goldstein spoke on a separate panel that focused on attempts to rectify human rights abuses in the Holocaust era with panelists from Italy, Spain, France and Belgium.

*November 15, 2009*

Charles Goldstein and Howard Spiegler spoke on Holocaust restitution issues involving Russia and Eastern Europe at a multi-day program in Boston sponsored by the American Association for the Advancement of Slavic Studies.

*November 15, 2009*

Lawrence Kaye delivered the Distinguished Annual Lecture at The McNay Museum in San Antonio, Texas. He discussed his work to reclaim for Jacques Goudstikker's heir art confiscated by the Nazis during World War II.

*November 20, 2009*

Charles Goldstein spoke at the NYCLA's Second Annual Art Litigation and Dispute Resolution Institute on the panel "Holocaust Restitution Claims: Courtrooms, ADR or a U.S. Restitution Commission?"

*November 30, 2009*

Howard Spiegler guest lectured for Professor Amy Adler's Art Law class at NYU Law School.

For questions about upcoming events and other Art Law matters, please contact:

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