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Art Collectors Beware of Uncovered Risks

by Frank K. Lord IV

In the Winter 2012 issue of *Art & Advocacy*, the article "Managing the Risks of Art Ownership with Insurance" provided an overview of basic considerations that should be taken into account when insuring artworks. That article noted that while most fine art insurance is termed "all risk coverage," it does not actually cover all risks because (1) there are particular losses that do not result from physical damage, and (2) policies typically contain exclusions for certain kinds of damage. This article will look at some of those exclusions and other potential risks of which owners of fine art should be aware.

Standard fine art insurance policies focus on losses caused by physical damage to artwork, which means that some significant risks may require separate coverage or are simply not covered at all. Chief among these are issues regarding good title and authenticity.

One of the most basic questions about works of fine art is whether the purchaser actually acquired good title. In the vast majority of transactions, this is not an issue: Good title typically transfers to the purchaser in the ordinary course of a transaction. Problems arise when a collector unknowingly acquires a piece that has previously been stolen or when other issues impair the purported owner's ability to transfer clear title. In the case of stolen artwork, under general principles of common law in the United States, a thief cannot pass good title, so no one further down the chain of ownership—not even a good-faith purchaser for value—will have a better right to the property than the original owner. Absent a valid defense, such as the expiration of the statute of limitations on the original owner's claims, a purchaser can be forced to surrender an artwork that was previously stolen.

In such a case, a collector may look to the seller to recover the purchase price, but recovery may not be possible if, for example, a dealer has subsequently gone out of business or the statute of limitations on the purchaser's claim has expired. In the worst case, a good-faith purchaser can find himself without both the artwork and the money he paid for it. A careful collector will look for ways to reduce this risk. The first is to diligently examine the provenance of an artwork before an acquisition. This process can identify potential risks, such as a gap in provenance during the Nazi era, so that the collector can evaluate them. If provenance or other issues cannot be resolved, one possible solution is title insurance. Title insurance has long been available for real property, but only recently became available for fine art and other important collectibles. According to Judith Pearson of ARIS Title Insurance Corporation, "the art market has changed substantially in the last decade and there has been a corresponding increase in title disputes. Collectors who undertake good due diligence often can reduce the title risk, but, because the art market is not transparent, cannot eliminate it altogether. Potential title challenges facing today's buyers in most cases will persist until the buyer-collector or their heirs decide to sell or transfer a work. Title insurance shifts this indefinite risk to protect collectors' art assets."

Another area of concern is the authenticity of an artwork. Just as insurers will not generally cover losses due to lack of title, they also will not pay for a loss in value stemming from the reattribution of an artwork or from a determination that an artwork is an outright forgery. Carefully checking the provenance of an artwork and consulting with experts prior to an acquisition can help reduce this risk, but authenticity is ultimately an inherent part of the art market that collectors must come to terms with.

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Art Collectors Beware of Uncovered Risks *(continued from page 1)*

Caring for art collections, particularly larger collections, requires a certain amount of ongoing administrative work. Although tedious, it can be critical. Jonathan Crystal of insurance broker Frank Crystal & Company says, "there is no insurance against bad administration." Simple mistakes can lead to large problems down the road. For example, a collector whose fine art insurance includes a schedule listing the insured items in his collection might forget to add a new acquisition, or a piece might be left off the schedule by accident. In the case of a new acquisition, there is often automatic coverage for some period of time after the purchase even if the item has not been placed on the schedule, but after that grace period expires, there could be no coverage for it. If a collector has many works spread over multiple residences, an inadvertent omission may be all too easy. Insuring under a blanket policy (as opposed to a scheduled policy) can protect against some of these problems, but depending on the collection, that might not be the least expensive or best approach. A consultation with an insurance broker experienced in the art insurance field can help a collector make an informed decision about the appropriate type of insurance or understand the terms of the coverage that is already in place.

Making sure that a collection is properly valued is as important as ensuring that the individual works are correctly listed. Having correct valuations is both a short- and long-term issue. Crystal cites contemporary art and Chinese antiquities as examples of fast-moving markets that a collector may need to watch carefully even in the short term. In the current climate, values might increase rapidly over a period of months, potentially leaving an inattentive collector underinsured. Similar problems can arise in more staid markets, although increases in value may take years to accrue. Crystal further warns that, "although they may give collectors some comfort, relying on the protections of the 'market appreciation' provisions that are found in many policies can be a mistake." Under these provisions, with certain limitations, insurers may agree to pay up to 150% of the listed value of a work to account for changes in the market. Here again, however, a dramatic increase in value can, over time, leave the collector underinsured. Regardless of the type of works in his collection, it is important for the collector to make sure that valuations are made on the basis of appraisals by qualified appraisers and that those valuation are regularly monitored.

"Loans of artworks for exhibitions—whether at museums or private galleries—are one area where both borrowers and lenders can get into trouble," says Steven Pincus, managing director of Dewitt Stern in New York. Where a loan agreement provides that the borrower's insurance will cover an artwork while it is on loan, both parties should carefully review their respective insurance coverage. Loan agreements often make only general references to the borrower's insurance without including details. Consequently, lenders need to be sure that they understand the exclusions and limits on the borrower's coverage. At the same time, borrowers need to be sure that insurance terms that were agreed to when negotiating with lenders are congruent with the underlying terms of their policy. A borrower that enters into a loan agreement promising coverage to the lender that is beyond the limits of its policy may find itself liable for damage that is not covered under its policy. A lender that accepts guarantees that are beyond the limits of the borrower's policy would have to rely on the borrower's, instead of the insurance company's, ability to pay in the event of a loss.

Pincus notes that, "coverage for terrorism is one place where a collector's policy and the coverage offered by a borrowing institution or gallery might differ significantly." An individual's "all risk" policy will typically not exclude damage caused by a terrorist act, but terrorism coverage is not automatically included as part of insurance policies for museums and art dealers. A museum or gallery that wants terrorism coverage must purchase it separately. In 2002, following the terrorist attacks of September 2001, the Federal Government created the Terrorism Risk Insurance Act ("TRIA"), which is essentially a risk-sharing partnership between the Federal Government and the insurance industry regarding terrorist attacks. The law has been twice extended, most recently by the Terrorism Risk Insurance Program Reauthorization Act ("TRIPRA") of 2007, which extended the law to 2014. TRIPRA is a complex law, containing many restrictions and exclusions that should be discussed with an insurance professional when it may be applicable. Even with TRIPRA, coverage may not always be available at reasonable rates, particularly in areas where there is an unusually high concentration of risk. This may include, for example, certain areas of Manhattan.

Although terrorism may be covered under an individual's fine art insurance policy, "all risk" policies typically list exclusions for damage caused by other specific risks. Standard exclusions include damage during conservation/restoration work, and damage caused by ordinary wear and tear, gradual deterioration, moths and vermin, acts of war, or radioactivity. The exclusion for damage during conservation/restoration work warrants particular attention. A good conservator will be well trained and exceedingly careful, but as a practical matter, any time that work is being done on an art object, the risk of damage is increased. Nonetheless, many independent conservators have no professional liability insurance because it is prohibitively expensive. Eryl Wentworth, executive director of the American Institute for Conservation of Historic and Artistic Works, describes this, along with related issues, including contractual protections, as a "major area of concern in the field."

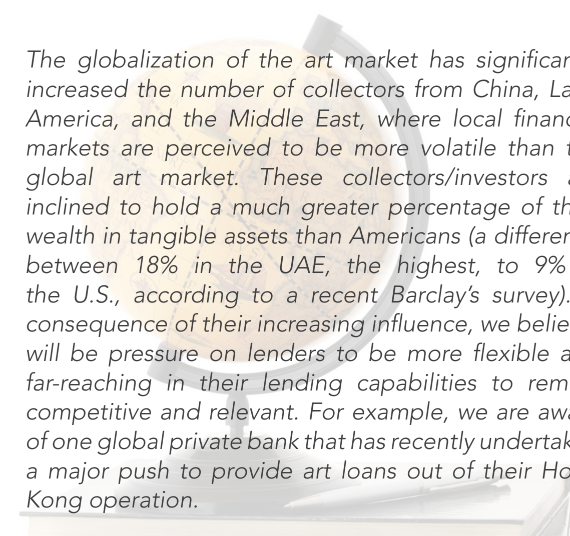
Paul Messier, a Boston conservator specializing in the treatment of photographs and former board member of the Institute, explains that conservators will often disclaim liability for damage during conservation in their contracts, leaving the risk with the owners. Messier views this as a practical consideration: "Museums do not hold their conservators liable for damaging a work of art, and independent conservators need to have the same standard applied so that they are not constantly exposed to potential losses if a treatment goes wrong. Limitation of liability is the foundation of any conservator's practice." For the collector, the combination of the exclusion in the insurance policy and the conservator's desire to limit liability leave open the possibility that there may be no insurance at all for their artwork at a moment of heightened risk. Collectors should have their insurance policies reviewed by an insurance broker and should consult with an attorney about contracts with conservators prior to any conservation/restoration work.

A good fine art insurance policy is the basic protection that all collectors need. But even after coverage is in place, careful monitoring—both of the policy and the collection it covers—is required. Managing risk should be high on the list of any collector's concerns, and effective risk management may require consultations with insurance brokers, appraisers, attorneys, and others.

The Risk Calculus of Art Loans: Lending Against Value in an Extraordinary Market

by Stephen D. Brodie

Various publications have recently noted a sharp increase in the number of loans secured by fine art as collateral. Over the past couple of years, Herrick has represented several banks and other lenders, as well as some borrowers, in closing many such deals. We have also advised several potential lenders, new to this field, in formulating a credit policy for art loans. It almost looks as if art lending is an idea whose time has come, an easy business that has been heretofore overlooked for some strange reason. In fact, it is not uncommon for private banks to make these loans at interest rates not far above the rates they charge on their securities-based (margin) loans, making it appear that art loans are not even that risky. The truth, however, is more complicated. The recent escalation in prices for art generally, and for contemporary art in particular, has sparked new interest in this kind of financing, as collectors and dealers have sought to monetize these increasingly valuable assets. Karen Boyer, a Manhattan art advisor, notes: "More and more of my clients are perceiving art loans as an easy and inexpensive source of capital, whether they are using the funds to buy more art or invest in their own businesses." Additionally, according to Michael Plummer and Jeff Rabin of ArtVest Partners, a financial art advisory firm in New York:



> *The globalization of the art market has significantly increased the number of collectors from China, Latin America, and the Middle East, where local financial markets are perceived to be more volatile than the global art market. These collectors/investors are inclined to hold a much greater percentage of their wealth in tangible assets than Americans (a difference between 18% in the UAE, the highest, to 9% in the U.S., according to a recent Barclay's survey). A consequence of their increasing influence, we believe, will be pressure on lenders to be more flexible and far-reaching in their lending capabilities to remain competitive and relevant. For example, we are aware of one global private bank that has recently undertaken a major push to provide art loans out of their Hong Kong operation.*

At the same time, fears of a bubble have increased anxiety about extending credit against art collateral. This article will examine how and why art lending gets done as it does today, despite the risks involved, most of which are either especially acute in, or actually unique to, situations where a loan is secured by art.

Unique Risks

The first thing most people observe when they begin to think more seriously about an art loan is that (other than jewelry or precious gems, both of which are rarely accepted as security for a loan) there is no form of collateral having great value that is as mobile as fine art. Unlike a ship or a plane, for example, art carries no flag of registry or identifying marks or numbers. Unlike real estate, art can be (and surprisingly often is) stolen. In addition, art has sometimes been forged well enough to fool even top scholars in the field, as was well documented by Jonathan Lopez in *The Man Who Made Vermeers: Unvarnishing the Legend of Master Forger Han van Meegeren* (Houghton Mifflin Harcourt Publ'g Co. 2009). And, if that isn't enough, no other form of collateral is vulnerable to a precipitous loss of value owing to a change in the preponderance of scholarly opinion as to its source. Nonetheless, private banks usually allow their clients to retain possession of art collateral, and do not require any title insurance to address the risk of a break somewhere in the chain of title. Under U.S. law, a theft might well void the client's title (and the lender's security interest), even if the client is an innocent purchaser who had paid an arm's length price. There is no insurance against a forgery or a change in experts' attribution of a work to a lesser artist, or to the "school of" a famous artist, rather than the famous artist. Of course, one can demonstrate that, overall, the risks of art collateral disappearing, provenance proving to be flawed, forgery, and misattribution are all somewhat remote. This argument may be cold comfort to credit officers at banks that have thus far declined to get into this business, but it is a sound conclusion statistically, and lenders who are active in the field are well aware of it.

Valuation Risk

What is not at all remote, however, is the valuation risk inherent in every art loan. Determining the "true" value of art today is a much discussed and controversial subject, both in and out of the lending sphere. But concerns about collateral value are hardly unique to art lending. The danger of not knowing what your collateral will be worth in the future (when you might actually need it) is a concern with any kind of secured loan. Whether it's real estate, stock in a closely held business, a plane, a yacht, or art, lenders routinely obtain appraisals, establish advance rates (i.e., percentages of appraised value against which they will extend credit), and then determine the amount they are prepared to lend against a particular pool of collateral. Federal law generally requires that a real estate appraisal for loan collateral purposes be made by an independent appraiser, that the date of valuation be not more than one year prior to the date of the loan, and that the loan-to-value ratio be less than 85%. The credit policies of banks for other types of secured loans follow similar guidelines. Although the problem is not specific to art, the valuation risk posed by art as collateral is probably greater than with any other kind of property. One difference is that the value of an artwork is so highly dependent upon taste, cultural trends, speculation, and a host of entirely subjective factors. But the special difficulties presented in valuing art go beyond even that. As Artvest Partners said in their Fall 2011 newsletter: "The art market is remarkably different from all other asset classes—it is opaque, illiquid, unregulated, non-commoditized and emotional." *Investing in Contemporary Art–What You Need to Know*, ArtVest Investment Advice for the Art Market, Fall 2011 at 4.

Much has been written in recent years about the economics of the art market, particularly the contemporary art market. Although the subject is interesting for many reasons, for this analysis, the important consideration is that if today's prices are inflated, as many believe, a lender's risk is correspondingly enlarged. This is because when a lender accepts an appraisal, it is relying upon a "snapshot" valuation in order to "size" its loan by application of the industry-standard 40-50% advance rate. And even though a proper appraisal for loan collateral purposes will be on the conservative side, no appraisal can ever be wholly disconnected from the overall market at the time in question. As Victor Wiener, who was executive director of the

Appraisers Association of America for 21 years, said (in reference to paintings selling at prices above $100 million) in an article entitled, *Appraising Art in the Stratosphere: The Dynamics of Steve Wynn's Elbow and Other Valuation Situations*, Journal of Advanced Appraisal Studies (2011) at 65: "Whether these prices represent the high end of a bubble or not, appraisers are obliged to take such high sales into consideration and, in some cases, they may be reflected on insurance appraisals or appraisals done for collateral loan transactions."

Regardless of the methodology, a perfectly executed appraisal will only provide an estimate of value as of a specific date. Later in the same article, Wiener comments that it is the professional responsibility of an appraiser to perform a market analysis in determining value. He then says: "If the situation is such that an actual sale is an anomaly, the appraiser has a responsibility to comment on this. In determining true market conditions, an appraiser must determine whether a specific sale is likely to take place a second time, on or about the effective date of valuation." *Id.* at 69. Wiener says that the goal is to identify bubbles. But many people think that the essence of a bubble is that you can't be sure it exists until it bursts.

The future of a market as "opaque" and "emotional" as contemporary art is all but impossible to predict. No appraisal can predict the direction (or directions) from which the winds of change will next be blowing—and they are always blowing and often changing. And contemporary art, which is often offered as collateral for loans at the present time (because so many older works are not in private hands), is by far the most susceptible to changes in culture and taste. This limitation is true for appraisals of any kind of asset. But there is better visibility of the future with real estate (whether commercial or residential) and businesses of almost any type, where income and expenses, and profitability over time, can be measured with coverage ratios and other financial tests.

Another, perhaps more fundamental, weakness in valuing art collateral is that even top-notch appraisers (with good contacts among dealers) cannot see the entire market. Auction prices are, of course, readily available, but it is widely believed that no more than half of all art sales are made at auction. By way of comparison, this is quite different from real estate, where, because deeds are public record, prices paid generally become public information. Moreover, for most types of business, appraisers can look at balance sheets, income statements, and cash flows to get a relatively firm handle on current value. The opacity of the art market means that all appraisals are necessarily somewhat flawed before you even get to a bank's real problem—the inherent volatility brought on by the non-economic forces that influence or determine the value of any kind of art, particularly contemporary art.

In today's art market, it is almost impossible to feel sure-footed when deciding how to weigh the credit support provided by art collateral. One of the New York art appraisers used by JPMorgan Chase's private bank said earlier this year that "[t]he market is currently extremely strong and international in scope. The factors contributing to this, international as well as national, are varied, and the market could, therefore, change at any time. It is also, however, extremely particular, and what is 'in' one day may not be 'in' another day."

Moreover, there are many who believe that the contemporary art market is subject, at present, to significant manipulation. Concerns abound about financial manipulation by art investment funds and speculators trying to drive prices up or down for their own purposes. But "manipulation" can mean more than just this. In his 2008 book on the contemporary art market, *The $12 Million Stuffed Shark* (St. Martin's Press 2008 at 26), Don Thompson noted that:

> Of the several artists who had serious gallery shows in New York and London in the 1980's, no more than twenty were offered in evening auctions at Christie's or Sotheby's in 2007 ... in the end, what is judged to be valuable contemporary art is determined first by major dealers, later by branded auction houses, a bit by museum curators who stage special shows, very little by art critics, and hardly at all by the buyers. High prices are created by branded dealers presenting particular artists, by a few artists successfully promoting themselves, and by brilliant marketing on the part of brilliant auction houses.

In his 2011 book, *Art of the Deal: Contemporary Art in a Global Financial Market* (Princeton Univ. Press 2011 at 5), Noah Horowitz pointed out that it is "worth remembering that global art price levels, commonly believed to have shattered previous records for years on end during the latest boom, actually drew level with their peak of 1990 in 2007-2008.... Nor should we ignore the fact that three of the top five most expensive art works ever sold at auction in real terms still hail from the 1980's." The story behind this is that there was a bubble that burst in the early and mid-1990's. One can, of course, look at that fact in two different ways: with historical perspective, today's prices don't seem quite so high; but whatever was up in the late 1980's and 1990 did indeed come down. It all speaks of volatility.

A New Paradigm?

Evident as the possibility (or probability) of a bubble may be, it is only one side of this story. There are arguably forces abroad in our economy and culture that may be making for a paradigm shift. Horowitz points out that:

> There has never been such an intense and widespread focus on the economics of art as there is today; market information is more exhaustive and accessible, leading people to be more savvy about the benefits of art as a specifically financial asset... The net effect is that more money, from more places, has been poured into the art market than ever before, inspiring ever more creative ways to put this capital to work. *Id.* at 7.

Horowitz goes on to analyze various statistics and to conclude that "contemporary art has never been more popular, and there has been a generational shift in the focus of art collecting from objects of an established past to those of a present that is still in formation...." *Id.* at 8. In addition, Boyer believes that, "[a]s lending against art continues to become more accepted and popular, it will add some much needed liquidity to a historically illiquid market, further strengthening the market as a whole." After the bursting of the dot-com bubble, however, no one should insist too strenuously that we are looking at a new paradigm of any kind. But history shows that even very big things sometimes change, and there are plainly sweeping changes occurring in the world today that may be making contemporary art more desirable, and more important, than ever before. Social media, globalization, and celebrity culture all appear to be involved. Consider this observation by Horowitz (*id.* at 9):

> Lastly, contemporary art has become a global phenomenon. This has profoundly shifted the dynamic of the trade.... Even if we acknowledge that record prices are always relative, there is no denying that influential buyers and sellers of art have seeped well beyond the conventional Euro-American axis, enabling contemporary art to transgress linguistic and cultural boundaries in a way that few other outlets can: it has become a veritable social glue. This is particularly vital nowadays, for in a globalized world split by social, political, and religious strife, contemporary art is a leveling force offering a tabula rasa relieved of history and anchored to the spirit of progress, innovation, and inclusivity. More types of art are being seen, produced, and collected by more artists and audiences internationally than in any previous period, and the more diverse and pluralistic this work becomes, the more these attributes are reinforced.

The Risk Calculus

All of this is enough to make a lender's head spin. Although paradigm shift is an interesting, or even a compelling, possibility, and may, in fact, influence the thinking of certain niche, asset-based art lenders, it is not likely to contribute materially to a private bank lender's thought process. So, can lenders truly get comfortable applying their customary 40-50% advance rates to values that run a patent risk of not standing the test of time?

A private bank that is willing to lend against art collateral (often consisting of contemporary art) does so with several important safeguards built into the deal. First, the borrower is typically an ultra-high net worth individual (or at least a high net worth individual), with the ability, at the time the loan is made, to pay it off or to post good quality, additional, or substitute collateral if there is a problem. Second, most art loans require compliance with ongoing net worth and liquidity covenants that are tested at least once a year. Third, the lender will often insist that its security consist of a diversified pool of art collateral so that it does not bear a concentration risk if a particular artist falls out of favor. Fourth, the vast majority of all art loans are short-term, typically with one- or two-year maturities. Fifth, in our experience, most art lenders impose an ongoing loan-to-value maintenance test on the borrower, with post-closing appraisal rights (at the borrower's expense), at least once a year. And lastly, the lender only advances at a rate of not more than half of the appraised value. Another factor for private banks is that they receive (or will have the opportunity to receive) substantial supporting business from the wealthy collectors to whom they lend.

But what about the non-bank lenders? They are not cross-selling to their borrowers, and they are often lending on a non-recourse basis to people who are not financially strong enough to easily pay off their loans or to provide other acceptable collateral if there is a default. What they receive is more fees and interest rates that are much higher than those charged by private banks, and they almost always take possession of the collateral, thereby eliminating entirely the mobility risk, which is a risk that the banks generally have to endure.

The Future

The trend of increasing demand for loans of this kind seems likely to continue until a bubble bursts or some macro-economic forces precipitate a retrenchment. Accordingly, one might expect to see some evolution in the way the art lending business is done. While it would be foolish to make predictions that depend on the performance of the economy or yet unseen cultural trends, one can note a couple of directions in which things may move, all other things being equal. There is at least talk of some new asset-based art lenders entering the field, charging interest rates in between those of the banks and the existing niche lenders. Title insurance is currently available to lenders, but it is quite expensive and excludes from coverage issues of attribution and authenticity. If premiums come down, title insurance is likely to become a more widespread requirement.

This year, Herrick closed a private bank loan that presented various issues, including provenance and attribution. The lender insisted on title insurance, as it provided a solid mitigant to at least one of the bank's key concerns. This proved to be just enough to adjust the risk calculus in favor of doing the deal.

The most likely application of title insurance in the future may be with asset-based lenders, who would surely be eager to eliminate provenance as a risk if they could make it "market" to do that. No matter what happens with interest rates or title insurance, it seems safe to expect that the dangers and mitigants involved in art lending risk calculus will remain the same for the foreseeable future.

California Resale Royalty Act: A Nail in the Coffin After 35 Years

By Barry Werbin

In 1977, the California state legislature enacted a statute to provide additional compensation to fine artists each time their works were resold by California sellers or otherwise within the state of California. Entitled the California Resale Royalty Act ("CRRA"), the California statute[1] embodied a form of *droit de suite*, a legal concept that has become engrained in European art law.[2] *Droit de suite* creates a "'continuing remunerative relationship between a visual artist and his creation,' by providing the artist with a right to a royalty payment—consisting of a percentage of an original work's resale price—each time the 'original, tangible embodiment' of the artist's work is resold."[3] The CRRA was the first, and remains to date the only, *droit de suite* legislation in the United States.

Under the CRRA, "[w]henever a work of fine art is sold and the seller resides in California or the sale takes place in California, the seller or the seller's agent shall pay to the artist of such work of fine art or to such artist's agent 5 percent of the amount of such sale." Cal. Civ. Code § 986(a). This royalty right can be waived by an artist "only by a contract in writing providing for an amount in excess of 5 percent of the amount of such sale." *Id.* The CRRA excludes any resale where the gross sales price is less than $1,000. § 986(b)(2).

The CRRA defines a work of "[f]ine art" as "an original painting, sculpture, or drawing, or an original work of art in glass." § 986(c)(2). An "[a]rtist" is defined as "the person who creates a work of fine art and who, at the time of resale, is a citizen of the United States, or a resident of the state who has resided in the state for a minimum of two years." § 986(c)(1). Upon the death of an artist, the rights under the CRRA inure to the artist's heirs until the 20th anniversary of the artist's death. Thus, despite the law being enacted only in California, the CRRA applies to all artists who are U.S. citizens, regardless of the state in which they reside.

The CRRA additionally requires the seller's agent (including a "gallery, dealer, broker or museum"), to pay the resale royalty. The agent must "withhold 5 percent of the amount of the sale, locate the artist and pay the artist." If the agent cannot locate the artist within 90 days, the agent must pay the applicable royalty to the California Arts Council, which is then required to search for the artist for seven years. After that time, if the artist cannot be located, the funds are to pass to the California Arts Council for "use in acquiring fine art." If the seller or the agent fails to pay the royalty, "the artist may bring an action for damages within three years after the date of sale or one year after the discovery of the sale, whichever is longer." § 986(a)(3).

After 35 years, in the consolidated cases of *Estate of Robert Graham v. Sotheby's Inc.* and *Sam Francis Foundation v. Christie's Inc.*, a United States District Court in California for the first time ruled on May 17, 2012, that the CRRA was unconstitutional because it violated the Commerce Clause of the U.S. Constitution (*see* Note 3). A class of artists and their heirs – including famous pop artist, Chuck Close, who resides in New York – filed a class action lawsuit against Sotheby's, Christie's, and others acting as agents for California sellers, for selling works of art at auction without payment of the requisite royalty under the CRRA. In January 2012, the defendants filed a motion to dismiss the case on the grounds that the statute (1) violates the Commerce Clause of the United States Constitution; (2) effects a taking of private property in violation of the United States and California constitutions; and (3) is preempted by the Copyright Act of 1976.

A handful of prior legal challenges to the CRRA have failed, primarily based on a preemption claim under the Copyright Act, which has exclusive jurisdiction over all claims that encompass rights equivalent to the bundle of exclusive rights reserved to a copyright owner. In particular, the "first sale doctrine," codified in Section 109 of the Copyright Act, provides that once a copyright owner sells or otherwise disposes of a copyright-protected work, the copyright owner can no longer control the future sale or disposition of that work.[4] In December 1992, the Copyright Office issued a report concluding that it was "not persuaded that sufficient economic and copyright policy justification exists to establish *droit de suite* in the United States."[5]

Soon after the CRRA was enacted, it was challenged unsuccessfully as being a violation of the copyright first sale doctrine and, therefore, preempted by federal copyright law. On the appeal in that case, *Morseburg v. Balyon*, the Ninth Circuit Court of Appeals in California upheld the law under what was then the prior Copyright Act of 1909, finding no preemption because, unlike the 1976 Copyright Act (which did away with common law copyright), the 1909 Act contained no federal preemption provision.[6] No challenge was raised to the CRRA under the Commerce Clause.

In April 2011, faced directly with a preemption challenge in Baby *Moose Drawings, Inc. v. Valentine*, another California District Court declined to find that the CRRA was preempted by the 1976 Copyright Act because "the Copyright Act's preemption analysis only requires an examination of the exclusive rights reserved to a copyright owner under 17 U.S.C. § 106," as opposed to state law claims concerning a violation of the limits imposed by the first sale doctrine under Section 109.[7] No appeal was taken from that decision and the issue of preemption under the 1976 Copyright Act remains hotly debated to this day.

In the May 2012 decision in *Estate of Graham*, yet another California District Court held that the CRRA violates the Commerce Clause and is unconstitutional. To understand why, a brief primer on the Commerce Clause, as explained by the California District Court, is in order. The Commerce Clause states: "The Congress shall have Power . . . [t]o regulate Commerce . . . among the several States…."[8] Although the Clause is phrased as an affirmative grant of regulatory power to Congress, the U.S. Supreme Court has interpreted the Clause as having a "negative aspect," referred to as the "'dormant Commerce Clause . . . .'" Under this construction, the court noted, states do not have the "'power [to] unjustifiably . . . discriminate against or burden the interstate flow of articles of commerce.'" The Clause thus is a limitation on the powers of the states, which must "even-handedly regulate to 'effectuate a legitimate public interest,' and its impact on interstate commerce must only be 'incidental.'" A state statute is unconstitutional under the Clause if it either "'(1) directly regulates interstate commerce; 2) discriminates against interstate commerce; or 3) favors in-state economic interests over out-of-state interests.'"

Against this background, the court found the CRRA invalid under the Commerce Clause because: (1) works of fine art sold from one state to another are "things" in interstate commerce that can be regulated by Congress; (2) the CRRA "substantially affects interstate commerce" (noting that the Ninth Circuit in its *Morseburg* decision described the CRRA as "an economic regulation to promote artistic endeavors generally"), particularly when "the number of art sale transactions throughout the United States that the CRRA purports to regulate are considered in the aggregate"; and (3) "the CRRA explicitly regulates applicable sales of fine art occurring wholly outside California, so long as the seller resides in California" (even if the artist, such as plaintiff Chuck Close, is not a citizen or resident of California). The court held that "[f]or these reasons, the Court finds that the CRRA has the 'practical effect' of controlling commerce 'occurring wholly outside the boundaries' of California even though it may have some 'effects within the State….'' Therefore, the CRRA violates the Commerce Clause."

Having so ruled, the last question the court had to tackle was whether the entire statute should be ruled invalid or whether it could be salvaged by limiting it, for example, only to sales that actually occurred within California between California buyers and sellers. The CRRA itself contains a "severability" provision, which likely was included in anticipation of future legal challenges. The District Court noted that Supreme Court precedent provides that "'[t]he more relevant inquiry in evaluating severability is whether the statute will function in a manner consistent with the intent of [the state legislature].'" The District Court concluded that the "legislative history of the CRRA … reveals that the [California] legislature abandoned the initial version of the CRRA that purported to regulate only sales that took place in California." Further supporting the court's conclusion was advice given by the California Legislative Counsel, which in 1976 advised then-Governor Gerry Brown, in opinion letters, that the CRRA bill "would constitute an undue burden on interstate commerce in contravention of the Federal Constitution in its application to sales which occur outside the State of California." As a result, the court found that the California legislature "would not have enacted" the CRRA without its extraterritorial reach, and for the court "merely to sever the extraterritorial provisions of the statute would create a law that the legislature clearly never intended to create…. Therefore, the Court finds that the CRRA must fall in its entirety."[9]

The plaintiffs in the consolidated cases have filed an appeal to the Ninth Circuit Court of Appeals. They also filed a motion to stay enforcement of the court's ruling pending the appeal, but that motion was denied on June 6, 2012, by a different District Court judge, who was assigned the motion because the judge who issued the main decision was elevated in May to the Ninth Circuit. The court explained that it denied the stay because the decision did not actually grant any affirmative relief, but rather only granted the motions to dismiss the claims.[10]

While the *Estate of Graham* court found the CRRA unconstitutional, it is an opinion of only one federal district court, and other courts may decline to adopt it if challenges are raised in other jurisdictions. How the Ninth Circuit will rule is anyone's guess. Although that Court had upheld the CRRA in its early *Morseburg* decision, as noted, that case did not involve a challenge under the Commerce Clause. Whether auction houses and galleries will now cease complying with the CRRA altogether based on one District Court's decision remains to be seen. The district judge who denied the stay motion opined that some may be "emboldened by the Order to flout the Act — or continue to flout it, as the filings suggest. If so, higher courts will determine whether the Act deserves that scorn… The Order will have as much or as little influence as its reasoning deserves, and a stay would neither decrease nor increase its persuasive authority."

Sparked perhaps by the attention drawn to the CRRA, both the U.S. House and Senate introduced a proposed bill on December 15, 2011, entitled the "Equity for Visual Artists Act of 2011." This bill to amend the Copyright Act by adding a new Section 106(b) would require that whenever a work of art is sold at auction (other than by the artist and other than in Internet-only auctions), for at least $10,000, the entity receiving payment must pay a royalty of 7% of the price to the artist's "collecting society." An auction entity would only be covered if the "amount of such works sold [by it] during the previous year is more than $25,000,000." The "collecting society" would then have to distribute half the net royalty (after first deducting for itself an "administrative expense" not to exceed 18%) to the artist, or the artist's successor copyright owner, and deposit the other half into an escrow account to fund purchases by U.S. non-profit visual arts museums. The bill would make it an infringement offense for the failure of the entity collecting the sale proceeds to pay the royalty, and would subject an infringer to statutory damages (an odd construct as none of the exclusive statutory rights of a copyright owner under Section 106 would be violated otherwise).

Why the bill is targeting only major auction house sales and not gallery or museum sales is perplexing, and could have the practical effect of driving some sales of high-valued art out of the auction market to private sales or to new Internet-only auction sites. Moreover, how a new *droit de suite* statutory right would interplay with the Copyright Act's first sale doctrine remains to be seen, as it would make non-payment of the royalty an infringement offense, whereas the first sale doctrine expressly permits unlimited resales of copies of works under copyright once they leave an author's hands. In addition, a new breed of artist "collecting societies" could spring up to earn fees as high as 18%; query the wisdom of that outcome. The future of *droit de suite* in the U.S. may soon be played out in both the courts and the Congress.

1 Cal. Civ. Code § 986. The statute was enacted after a 1958 Robert Rauschenberg painting, originally purchased for $900, was resold in a 1973 auction for $85,000.

2 For example, the United Kingdom's Artist's Resale Right, which is based on the French "*Droit de Suite*" or "right to follow," grants artists the right to receive a royalty every time one of their works is resold at auction or by an art market professional. The majority of states within the European Union have similar laws.

3 *Estate of Graham v. Sotheby's Inc.*, 2012 WL 1765445, 103 U.S.P.Q.2d 1142 (C.D. Cal. May 17, 2012), discussed infra.

4 Section 109 provides: "[T]he owner of a particular copy…lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy…." 17 U.S.C. § 109.

5 U.S. Copyright Office, *Droit de Suite: The Artist's Resale Royalty* (1992).

6 621 F.2d 972 (9th Cir. 1980).

7 2011 WL 1258529 (C.D. Cal. Apr. 1, 2011). Section 106 of the Copyright Act delineates the exclusive rights reserved to a copyright owner, including rights of reproduction, display, distribution, public performance, and the right to create derivative works.

8 U.S. Const. art. I, § 8, cl. 3.

9 The District Court did not address the defendants' alternative grounds for invalidating the CRRA.

10 *Sam Francis Foundation et al. v. Christies, Inc.*, No. CV-11-8605 (Document 47), "Order Denying Ex Parte Application" (C.D. Cal. filed June 6, 2012).

11 H.R.3688 and S.2000, Equity for Visual Artists Act of 2011, with the expressed purpose: "To amend the copyright law to secure the rights of artists of works of visual art to provide for royalties, and for other purposes."

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Art Law Events

Upcoming Events Involving Herrick's Art Law Group

September 13, 2012

Irwin Latner will participate in a panel on art funds and Stephen Brodie will participate in a panel on art lending in a program entitled "Masters of Art Finance: Exploration of Art Loans & Art Investment Funds," sponsored by the Fine Arts and Membership Committees of the Entertainment Arts & Sports Law Section of the New York State Bar Association.

September 25, 2012

Stephen Brodie will participate in a panel on the art market, art investment funds, and investment risks for family offices sponsored by Landmark Capital Corporation in conjunction with ARIS Title Insurance Corporation.

October 3, 2012

Howard Spiegler will lecture at Christie's Education on developments in restitution law.

October 29, 2012

Frank Lord will be a panelist at the symposium on "Repatriation of Archaeological and Ethnographic Objects" sponsored by DePaul University College of Law Center for Art, Museum & Cultural Heritage Law, Chicago.

November 3, 2012

Howard Spiegler, President of the Art Law Commission of the Union Internationale des Avocats (UIA), and Mari-Claudia Jimenez, Secretary of the Commission, will present a program at the annual UIA Congress in Dresden, Germany entitled "Art as an Asset: What your clients need to know about collecting, transacting and investing in art." Larry Kaye and Steve Brodie will also be participating in the program along with attorneys from around the world.

November 11, 2012

Stephen Brodie will participate in a panel entitled "Art Financing and the Appraiser" at the Appraisers Association of America's National Conference being held at the New York Athletic Club in New York City.

November 27, 2012

Larry Kaye will participate in an International Symposium sponsored by the Dutch Restitutions Committee at the Peace Palace in The Hague, Netherlands entitled "Fair and just solutions? Alternative to litigations to Nazi looted art disputes: status quo and new developments."

Recent Events Involving Herrick's Art Law Group

July 19, 2012

Larry Kaye and Howard Spiegler presented an overview of Herrick's art law practice entitled "From Tomb Raiders in Turkey to Hitler's Crimes against Humanity" to the American Bar Association Foreign Legal Consultants Committee.

June 15-16, 2012

Larry Kaye and Howard Spiegler participated in the Symposium on Criminality in the Art World in Toronto, Canada, where they spoke on "What's Hot: Archaeological Theft, Antiquities and Nazi Looted Art—Why Should We Care?" regarding the fundamental principles and developing trends in recovery cases.

May 14, 2012

Larry Kaye, a member of the Legal Affairs Committee of the International Council of Museums (ICOM), spoke on "Immunity from Seizure for Cultural Property" at the ICOM Workshop for Mediators in Art and Cultural Heritage in London.

April 19, 2012

Frank Lord gave a lecture on the "Restitution of Holocaust Art" at Brooklyn College.

For questions about *Art & Advocacy*, please contact the Editor-in-Chief:

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Additional information on Herrick's Art Law Group, including biographical information, news, and articles, can be found at **www.herrick.com/artlaw.**

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