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### **Risks, Rules, and Opportunities in Art Investment**

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### **The Regulation of Art Investments in the United States<sup>1</sup>**

- I was asked to speak “on the rules that apply specifically to art and investment in art in the US”
  - There are none. To my knowledge, although various aspects of the art market are regulated there are no rules under US federal or state law that apply specifically to art funds or investment in art in the US
  - Instead, there are rules, structures, guidelines and principles that apply to:
    - indirect investment in art through the vehicle of a fund
    - direct investment in art by funds or individual investors

### **Indirect Investment: The Art Fund**

- No art fund is registered as a “public company” with the United States Securities and Exchange Commission
  - Securities Act of 1933, as amended, regulates the offer and sale of an issuer’s securities to the public
    - Public companies are generally regarded as those which register their debt or equity securities with US Securities and Exchange Commission in connection with an underwritten public offering
      - Offering documentation includes a “prospectus” which is included in the issuer’s “registration statement” with the SEC

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<sup>1</sup> This is an overview. It is not intended to be and does not constitute legal advice and may not be relied upon as such. We encourage interested parties to contact us with specific questions about investing in art, directly or through a fund.

- Securities Exchange Act of 1934, as amended, regulates the periodic reporting requirements of issuers registered under the Securities Act and their corporate insiders
  - Issuers must file annual, quarterly and periodic reports
    - Containing specific narrative and financial statement disclosure
  - Insiders must make annual and periodic filings of their direct and indirect “beneficial ownership” of company securities
    - Insiders include officers, directors and 10% shareholders, and acquirors of 5% or more of company securities
- Instead, art funds are generally a creature of the private market, and are not subject to the registration and reporting requirements of the Securities Act and the Securities Exchange Act.
  - Private art funds are not “transparent” to outside investors or analysts
  - Investment in art funds is generally accomplished through the issuance of securities in the fund vehicle, which is governed by “Private Placement” rules under US federal and state securities laws
    - Private placements of fund securities are generally governed under “safe harbor” exemptions from the registration requirements under the Securities Act, including Regulation D and Regulation S (which governs private placements to offshore investors outside the US)
      - Exemptions generally allow for sales of securities to an unlimited number of “accredited” individual investors and/or “qualified” institutional investors and a limited number of non-accredited investors
      - A notice of offering on Form D is generally filed
      - Compliance with state law “Blue Sky” rules and filings is also required, which is generally determined by the states in which the offerees and purchasers reside
      - Section 4(2) is the general exemption under the Securities Act for “non-public” offerings
        - It is not a safe harbor and is tested by facts and circumstances
        - Some private funds with a small number of investors with pre-existing relationships may simply rely on the “4(2)” exemption.
          - If there is no solicitation of third party investors and no need for an offering memorandum, the investors can simply sign a partnership or limited liability company agreement.

- Although exempt from the more rigorous registration and reporting requirements applicable to public companies, private offerings where outside investors are solicited are effected pursuant to a document package that generally includes:
  - Private Offering Memorandum
  - Organizational documents of the fund entity
  - Subscription documents
    - Investor representations as to their financial sophistication and qualification
  - The standard for disclosure in the Private Placement Memorandum is generally governed by potential liability under Rule 10b-5 under the Securities Act for “material misstatements or omissions.”
    - PPMs generally approximate the categories of disclosure by a public company prospectus:
      - The Offering
        - The type of securities offered, and their features (including priority distributions, preferential returns, voting rights, etc.)
        - The other features of the offering, including:
          - funding commitment
          - offering period
          - minimum and maximum offering amount
          - investor commitment period
          - drawdowns
          - investor defaults
          - reinvestment of capital
          - term and termination of the fund
      - The Fund
        - Description of the fund’s business and investment objectives
        - Management background
        - Management Fee
        - Expenses reimbursed for organization and operations
        - Distributions to equity holders

- Tax allocations
  - Capital accounts
- Risk factors and investment considerations
- Conflicts of interest
  - Exclusivity
  - Alternate investment vehicles
  - Allocation among affiliated funds
  - Co-investment
- Key person events
- Tax and pension law considerations
- Transfers and withdrawals
- Exculpation and indemnification
- Amendments to the fund documents
- Fund structure is governed by the laws of the state under which the fund entities are formed
  - Most funds are structured as a limited partnership or limited liability company, often but not exclusively organized under Delaware law
  - The investors will generally invest as limited partners or as a class of members in an LLC with limited voting and management rights
  - The general partner or manager will be a separate entity controlled by the fund sponsors, and will make a small capital contribution to the fund
    - The limited partnership or LLC agreement will provide for the management and operation of the fund vehicle and the rights, preferences, powers and priorities of the various classes of investors, including:
      - the payment of fees and expenses to the general partner or Manager
      - a waterfall of operating and liquidating distributions of net profits first to the partners as a return of capital (with the limited partners having a priority return over the general partner) and then a split of residual net profits, often 80% to the limited partners and 20% to the general partner (subject to negotiated exceptions in respect of priority and preferences and potential clawbacks of amounts previously distributed)
  - A separate management company, managed by the specialists or art advisors to the fund, will make the investment decisions by which the fund will buy and sell art.

- The management company may charge the fund a management fee which is additional to the general partner's returns under the limited partnership or LLC agreement.
- In short, art fund documents are generally similar to the documents that govern funds in other industries or asset classes, with two critical exceptions:
  - The description of the art market generally, and the market segment, if any, in which the fund intends to specialize:
    - e.g., coins, old masters, contemporary painting, etc.
  - the Risk Factors and Investment Considerations peculiar to and inherent in the art market, e.g.:
    - Lack of Diversification
    - General Risk of Investments in Art Assets
    - Risks Relating to Authenticity and Attribution
    - Title Risk
    - Limited Ability to Mitigate Risks relating to Authenticity and Title
    - Valuation of Art Assets
    - Value susceptible to changes in the market and critical influence
    - Investment in art assets by lesser-known artists
    - Potential illiquidity of art assets
    - Contingent liabilities on disposal of art assets
    - Adequacy of property and casualty insurance coverage
    - Non-U.S. investments
    - Currency risks
    - Partnership Expenses peculiar to the art market
    - Custodial risk
    - Government Approvals
    - Ability to Enforce Legal Rights

### **The US Experience with Art Funds**

- The financial performance of the larger, more ambitious funds appears to be mixed
  - Ranging from outright failure to modest returns (7%).
    - These funds are intended to mirror private equity funds in other asset classes, may suffer from high operating costs and expenses, and may not fully understand that fine art market does not necessarily behave like markets for other asset classes in terms of liquidity, transparency and financial performance.

- Fernwood, one of the earliest and splashiest funds, was an outright disaster:
  - The seed investors were defrauded by the principal and promoter, against whom they obtained a default judgment, and the fund closed its doors without buying or selling a painting (except paintings that the promoter bought for himself with Fund money).
  - The plaintiff investors remain persuaded that Fernwood could have succeeded as a special opportunity acquiror, buying low in the recession and selling high in the recovery.
- The financial performance of smaller, more outwardly modest funds may be better
  - This model is where a few specialists raise a moderate amount of capital (\$5-15 million) to trade in niche markets. These “friends and family plus” funds can be quite successful, especially if operating costs and expenses are kept low and the trading remains in a profitable, liquid mid-range of low five to low seven figures.
- One of the best informed private analysts of art fund performance has concluded that though the large fund concept has conceptual merit, significant investors who wish to participate in the art market generally prefer to do so directly, as collectors, rather than indirectly as investors in someone else’s fund.

#### **Direct Investment: The Art Collector (Funds and Individuals)**

- Despite the provisions for indemnification and exculpation contained in the fund’s organizational documents, fund managers and advisors have a quasi-fiduciary obligation to the investors to invest the fund’s money prudently. This entails:
  - Due diligence investigation of artwork acquired by the fund
  - Documentation that demonstrates a reasonable standard of care in buying and selling art assets
  - These standards of prudent investigation and sound documentation should govern the actions of all participants in the secondary market
- **Secondary Market**
  - Resale market for previously-owned work by living or deceased artists
  - Art market participants:
    - Private collectors
    - Galleries (brick and mortar establishments and on-line venues)
    - Independent advisors, consultants, appraisers and brokers
    - Auction Houses
      - international, national, regional
    - Museums
      - international, national, regional
- **The Buyer’s Concerns**
  - Price and Value

- The collector's most fundamental concerns with a work of art are related to price and value:
      - is the price commensurate with artist's reputation, quality of the work, current market value and potential for appreciation?
        - Current market value established by reference to sales of comparable work by the same artist and/or works by different artists.
        - Note that auction prices are transparent and tracked by Artnet and other indices
        - The private market is opaque; prices may not be transparent
    - The determination of value arguably becomes easier as a work of art, similar works or a particular artist build up a history of sale and resale (especially reported auction sales)
  - Provenance
    - Chain of title/ownership
      - Ideally, the chain of title stretches back to the artist's studio
        - under AAMD Guidelines, member museums cannot acquire ancient art without provenance to 1970
  - Provenience
    - Country or place of origin or discovery
      - Find spot of archeological material (aka antiquities) can make it subject to national patrimony laws
      - historically important material (e.g. artwork, manuscripts and other cultural objects produced before 1950) can also be subject to national patrimony laws
      - import/export compliance is an issue for most objects over 50 years old
  - Authenticity
    - Is it by the artist's hand?
    - If not, there is a progressively weaker scale of attribution (and price/value)
      - "attributed to," "studio of", "school of"
      - attributions are continually being reevaluated by art historians
  - Originality
    - Repairs, restorations, condition
  - Exhibition, Publication, Scholarly References
- **The Purchase Agreement (Private Sales)**
    - The Buyer should require the Seller to make "representations and warranties":
      - Title
      - Provenance
      - Provenience

- Import/export compliance
- Authenticity
- Exhibition, Publication, Scholarly References
- Originality/condition
- Customary individual and/or corporate representations
  - Capacity
  - Formation
  - Due authorization
  - Due execution
  - Enforceability
  - Non-contravention and third party approvals
- Relevant supporting documentation should be attached:
  - Expert's Authenticity Reports
  - Export permits
  - US Customs documentation
  - Art Loss Register reports
  - Condition reports
  - Physical description with dimensions and detailed jpegs
  - Schedules of exhibition, publication, scholarly references
- The complete Purchase Agreement should function as a “passport” for the work in order to facilitate future transfers of the work by sale or gift
- Indemnity. The Buyer should require the Seller to indemnify the Buyer for breach of the Sellers's representation and warranties:
  - Without a contractual right to demand indemnity, the Buyer must sue for breach, which is rarely a cost-efficient or timely remedy
  - Indemnity issues typically include:
    - Caps
      - limit the Seller's liability to the Buyer's purchase price?  
What about Buyer's legal fees and other expenses?
    - Baskets
      - Create some de minimus floor beneath which there is no recovery?
      - Tipping basket or a true deductible?
    - Survival period
      - Should Buyer's claims expire after a certain period?
      - Should certain fundamental representations (e.g., corporate authority, title, authenticity) survive for an extended period? Indefinitely?
    - Choice of law



- If no survival period is specified, the law governing the contract may provide one by default
    - In the US, the statute of limitations for contract claims under the Uniform Commercial Code is generally 4 years
    - In the UK, the statute of limitations for contract claims is generally 6 years
    - If no governing law is specified, that may be the first fight in any litigation
- **The Seller's Concerns (Private Sale)**
  - The Seller's goals in the Purchase Agreement mirror the Buyer's
    - The Seller should be prepared to give customary representations and warranties and indemnities regarding the painting or work or art, but should do its best to narrow the scope of its representations by negotiating appropriate qualifications as to its "knowledge" and "materiality" and to limit the survival of its indemnity obligations.
    - In general, the Seller should try to limit its representations to facts it knows (or should know after reasonable investigation).
      - Representations are not meant to allocate risk on the basis of unqualified or unsupported assurances.
      - The buyer can obtain additional comfort by negotiating for indemnity for specific risks.
    - The seller should, however, expect to give unqualified representations as to title and authenticity, which are critical issues for the buyer. This is especially so where the seller is a dealer and an expert in the field.
- **The Consignment Agreement (Auction Sale)**
  - The large, international auction houses (Sothebys, Christies, Bonhams) generally require the consignor (seller) to sign a detailed consignment agreement covering the matters discussed above and the terms of the consignment
    - These are standard forms and should be carefully reviewed and if necessary negotiated by the consignor
      - E.g., consignors should not allow the auction house to pass through their representations to the Buyer (i.e., the high bidder).
    - The consignor should retain the right to approve the final reserves and to review the high and low estimates
    - Starting with low to mid-seven-figure consignments, the auction house may be willing to:
      - bear all costs of selling the consigned lot (insurance, transportation, photography, outside experts, marketing, etc.)
      - reduce or eliminate the Seller's premium

- share the Buyer's premium ("Enhanced Hammer")
- **Sellers, Buyers, Agents and Intermediaries**
  - Transactions in today's art market often involve a seller and a buyer who are remote from each other, with one or more brokers or other intermediaries in between.
  - Unless the roles of the various intermediaries are clearly defined and documented, it can be unclear whether an intermediary is acting as a purchaser for immediate resale or a broker or advisor working for a commission.
  - The difference can be critical. For example, a buyer for resale may think of themselves as an agent working for a "commission" because their ownership is brief, but in reality they are in the chain of title, making a profit on the immediate resale of the work, and may be liable for the full value of the work by their buyer (even if that buyer is in turn purchasing for resale). (The issuance of an invoice to or by an intermediary would ordinarily indicate that they are acting as a principal and not an advisor.)
    - Ideally, a purchaser for resale should attempt to limit its liability by getting and giving identical back-to-back representations and indemnities from its seller and to its buyer.
  - By contrast, an advisor is paid a brokerage or consulting fee by another party (and not a profit on resale), is not in the chain of title or party to a purchase agreement and should have no liability to any party in the transaction for indemnity.
  - An intermediary can simultaneously limit its liability and retain control of the transaction if it is appointed as the seller's agent and attorney-in-fact with power to negotiate and sign the purchase agreements on behalf of the seller.
- **Partners, Partnerships, Agents and Authority (Actual and Apparent)**
  - Dealers will often pair up to share the costs of acquiring a work for resale and pool their contacts. These relationships are loosely referred to as "partnerships"
  - The rights and responsibilities of the so-called "partners" are often ill-defined.
    - Basic legal concepts such as agency, partnership and actual and apparent authority may need to be considered in order to clarify and define the rights and liabilities of the parties.
    - In a "general partnership" each partner has the "apparent authority" to bind and incur liability for the partnership, and each partner is responsible for liabilities of the partnership created by the other partners.
    - If the intent is not to create a general partnership, then the relationship needs to be reconsidered and restructured.