Art OF THE TIMES

The Magazine of the arts In SOUTH FLORIDA ◆ NEW YORK ◆ LOS ANGELES | www.artofthetimes.com

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Investing in Art-Secured Lending

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Mega-sized pensions and other "huge" investment pools require ginormous markets. Large securities firms and pension funds exclusively seek out opportunities that can accept billion-dollar investments. Most investors, without such voracious appetites, can do better in niche markets such as art-secured lending. This market is approximately $15 - $20 billion and growing nicely at 13%, as reported by Deloitte and Touche. It's big enough to be interesting, yet small enough to be attractive.

The stable and often increasing value of many works makes high-end art an appealing investment. Individual artworks, however, can be illiquid and difficult to value. The market lacks transparency, leaving casual collectors exposed to such risks. Yet, fine art is truly an international asset with its collateral value commensurately increased, notwithstanding the traditional caveats. One can sell a Picasso in New York, London, Tokyo, or Timbuktu to take advantage of currency fluctuations and to provide an attractive counterbalance to fixed location assets such as real estate.

Instead of purchasing a work of art outright, however, an interested investor can choose to extend a loan with fine art as collateral. Lending against fine art, with appropriate due diligence and risk mitigants in place, can offer an attractive return, short duration, less volatility, and multiple layers of downside protection.

Demand for art-secured lending is driven by collectors and dealers looking to access the value of their collections without selling any pieces. An art dealer or collector might want to fund art acquisitions, finance inventory, or pursue other opportunities. Selling the art to access the cash value can be a long, painful process. Borrowing against art allows the owner to avoid the lengthy sales process, taxes, and transaction costs.

The lender has the right to sell the art in the event of default, but even the most sought-after pieces have a limited number of potential buyers. If it takes longer than intended to liquidate the collateral, the rate of return will decrease. A low "loan-to-value" ratio gives the lender a buffer against extended transaction times and can result in a windfall if the net sales proceeds are larger than the amount owed.

Subjective factors such as tastes, cultural trends, and speculation drive value. Because each artwork is unique, the value can be difficult to measure. Without a recent sale, an appraiser must evaluate recent sales of similar works. Details on private sales are often hidden, so appraisers rely on public sales data from auction houses. In the event of default, a low loan-to-value ratio provides a cushion in case the art does not sell for the appraised value.

To create an annual index of art prices, Jianping Mei and Michael Moses assembled sales data for 45,000 different artworks that have been sold at auction multiple times. , The Mei Moses World All Art Index (the "Index") compound annual return was 5.26% from 1995-2015 and 7.89% from 1965-2015. As a lender, it is comforting to know that the collateral has appreciated over time.

Relying on the Index, however, has its flaws. According to the TEFAF 2017 Art Market Report, only 37.5% of artworks sold in 2016 were sold through auction houses. Additionally, the database does not include auctioned works that failed to sell. The Index should not be treated as the gold standard but should instead be used as one of many valuation tools available.

Price levels across different genres often do not move together. Similarly, values of works by certain artists are more volatile than others. Lending against works that exhibit lower price volatility gives the lender greater confidence that the buffer created by the loan-to-value ratio will provide adequate capital protection.

Determining authenticity is a crucial step in a full appraisal. Traditionally, provenance and analysis from art historians are used to determine authenticity for any given work of art. The lender must establish provenance – the history of ownership of a work of art – before accepting an artwork as collateral. Unexplained gaps in provenance could indicate that the artwork has been stolen or illegally exported in the past. Gaps in provenance are not always suspicious or irregular. Details on private sales are scarce. With older artworks, it is improbable that complete records have survived. As a result, works can be sold or accepted as collateral with some gaps in provenance. However, an investor would be cautious if considering a Gustav Klimt that vanished from records in Austria in 1940 only to appear again a few years later.

Authentication experts must also be wary of fakes and forgeries. John Drewe famously engineered a scheme with the assistance of painter John Myatt, who could imitate artists such as Braque, Matisse, Giacometti and Le Corbusier. Drewe concocted fake provenances for Myatt's works by gaining access to supposedly secure art archives to change the provenance of authentic paintings and insert fake records for Myatt's forgeries. Together they produced and sold over 200 forged works.

Authentication experts review the following:

• Certificate of authenticity

- Authentication boards and artist-endowed foundations, often established by the heirs of an artist, will issue a certificate of authenticity if they determine the attribution claim to be true.6

• Catalogue raisonné

- A set of documents detailing all known works produced by an individual artist, a catalogue raisonné includes the date, medium, provenance, dimensions and illustration of each available work.

• Invoices, appraisals, auction records, purchase agreements, correspondence, and other sales documents

- These documents are useful for determining the purchase price, condition, and location of a work as of a certain date.6

• Insurance certificates, exhibition records, appraisals, and photographs

- These records can provide a glimpse into the value, condition, and location of the art while in the possession of a particular owner.6

• Export permits, lawsuit records, scholarly articles, museum catalogues

- Generally available to the public, these documents may contain information about value, ownership, and location.6

• Stolen art databases

- Many databases for stolen art are accessible to the public, providing records on art that could be subject to cultural repossession.6

Some documents mentioned above may be lost or nonexistent, but each is useful if available.

It is critical that the lender obtain a legal right to seize or sell the collateral. In the U.S., lenders file a UCC financing statement to perfect a security interest in the collateral. This transfers legal ownership of the collateral to the lender if the borrower defaults on the loan. However, possession is 9/10ths of the law. What happens if the borrower decides to take off with the art? Art is lightweight and portable when compared to other real assets such as real estate and equipment. As a result, there is always the risk that the borrower will steal or hide the art if he or she defaults. Additionally, any litigation needed to recover the collateral from the borrower wastes time and resources. Taking possession of the art eliminates these risks.

One approach to lending against fine art is to source loans through a loan originator with experience working in fine art finance and/or at major auction houses. Preferably, the originator will create an alignment of interests by participating alongside the lender. Thus, the originator is directly invested in the success of the loans and is not simply collecting origination fees.

An experienced lender often creates a defined "buy box", which identifies desired loan terms and characteristics. Short duration loans with attractive rates and low loan-to-value ratios compensate the lender for the unique risks mentioned above. Furthermore, it is wise to loan against auction-worthy art. Art that is desirable enough to be accepted at the major auction houses (i.e. Sotheby's, Christie's, Bonhams, etc.) will be easier to sell quickly in an event of default.

To minimize risk, it is important to lend against multiple different works of art. Ideally, a diversified portfolio of collateral will include works of art produced by different artists across different genres and movements. Similarly, it is important to lend to multiple borrowers in order to reduce counterparty risk.

The loan process entails a number of agreements and documents that secure the collateral, define the loan terms, and set out the legal responsibilities of the borrower, loan originator and lender.

• Appraisal documents

- The appraisal should include the valuation, past sale prices, and provenance information. Avoid art from certain geographic regions and time periods, such as antiquities from the Middle East and North Africa. These works are at risk of being seized by their countries of origin under cultural repossession laws.

• Insurance certificate

- This insurance certificate is used as evidence of coverage and should include the term and amount of insurance. The lender should be listed as an insured. The policy should not be at risk of cancellation due to negligence on the part of the borrower, and coverage should be provided by a reputable insurance provider with experience insuring fine art.

• Promissory grid note

- This includes the amount, interest rate, default scenarios, and maturity date. It also establishes that the borrower is liable for certain expenses.

• Loan and security agreement (LSA)

- The LSA goes into further detail on the deal terms and the required security measures. Often there are prepayment penalties defined in the LSA that discourage prepayment or give the lender a boost in return if the borrower repays the loan early. Additionally, the LSA provides that the lender has received a signed financial guarantee as a final layer of security. This allows the lender to pursue all other assets owned by the borrower.

• Origination agreement

- This agreement all lays out all fees owed to the loan originator and establishes the originator's responsibilities. It also includes the sales commission and fees owed to the originator if the art is sold. This agreement should also define the relationship between the lender and loan originator, with the lender legally insulated as much as possible from the loan originator. With careful drafting, a Special Purpose Vehicle (SPV) built to house loans may be made "bankruptcy remote," with ownership transferred to the lender if the loan originator becomes insolvent.

In addition to the documentation outlined above, another security measure involves proper storage of the collateral. The art should be stored in a climate-controlled bonded warehouse of the lender's choosing. While the UCC is important, taking possession of the collateral eliminates the challenge of recovering the art. The lender should obtain pictures of the art in the storage crate or packaging, and save the warehouse receipt to guarantee that only he or she can remove the art from the warehouse during the loan.

Even with the security measures and documentation in place, it is wise to monitor the collateral and status of the loan. As Ronald Reagan often said, "Trust, but verify". One can never be too careful.

Armed with a deep understanding of the risks associated with art as an underlying asset, an investor is able to prepare for potential challenges. The structure outlined above provides both security and control, allowing the lender to access attractive returns provided by art-secured loans without excess exposure to the unique risks.

Our goal is to empower investors with this roadmap. For the self-directed, doing it on their own will suffice. However and at a minimum, we strongly suggest engaging a loan originator. Most want the watch only to tell the time versus learning how it was built, and for them our article may kindle interest and conviction for participation but they may seek an advisor for implementation. For this group, Shinnecock stands ready to help. We have provided a link to the full research paper: Creative Collateral: Lending Against Fine Art (http://www.shinnecock.com/articles/alt_lending/art_finance.pdf). We welcome all thoughts and comments on the paper as well.

1. Mei, Jianping, and Michael Moses. "Art as an Investment and the Underperformance of Masterpieces."
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3. Deloitte Touche Tohmatsu Limited, and ArtTactic. "Art & Finance Report 2016."
4. Pownall, Prof. Dr. Rachel A. J. "TEFAF Art Market Report 2017."
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