Spencer's Art Law Journal

Edited by Ronald D. Spencer

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Ronald D. Spencer

Editor's Note

This is Volume 7, Issue No. 1 of Spencer's Art Law Journal. This Summer issue contains one essay which will become available in August 2017. *So You Thought Your Art Was Adequately Insured? . . .*

This essay is about valuing loss or damage to art for purposes of an insurance claim.

The insurance "coverage amount" (the maximum amount of the policy will pay and providing the basis for calculation of insurance premiums) is naturally a focus for the insured art owner.

But, as a practical matter (because most insurance claims do not involve claims for the full coverage amount) the more relevant factor for the insured is how the insuror will value the damage claim.

Most art insurance policies are vague on the valuation method, providing, simply, that in the event of disagreement on the value of the loss, the insured and insuror will each retain their own appraisers, and, if the appraisers do not agree on the value of the loss, the dispute is to be submitted to an umpire or arbitrator, whose decision will be final.

Note, here, that this very common insurance valuation dispute resolution provision, limits the owner's right (because of the rather narrow scope of judicial review) to contest in court, the umpire/arbitrator's decision valuing a loss under the policy.

The art owner should recognize that, if there could be serious disagreements over the value of a loss/damage claim, the owner is putting himself in the hands of a decision-maker from whose loss/valuation decision there may be limited effective appeal.

--- *RDS*

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SO YOU THOUGHT YOUR ART WAS ADEQUATELY INSURED? IN VALUING YOUR LOSS, WILL YOUR INSUROR APPLY A SO-CALLED "BLOCKAGE DISCOUNT"? OWNERS OF NUMEROUS ARTWORKS BY THE SAME ARTIST (TYPICALLY ARTISTS' ESTATES AND MAJOR PRIVATE COLLECTIONS) MAY BE IN FOR A NASTY SURPRISE WHEN THEY MAKE AN INSURANCE CLAIM

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This essay addresses the valuation of loss or damage to art for an insurance claim. The insurance "coverage amount" (the maximum amount of the policy will pay and providing the basis for calculation of insurance premiums) is naturally a focus for the insured art owner. But, as a practical matter (because most insurance claims do not involve claims for the full coverage amount) the more relevant factor for the insured is how the insuror will <u>*value*</u> *the damage claim. Most art insurance policies are vague on the valuation method, providing, simply, that in the event of disagreement on the value of the loss, the insured and insuror will each retain their own appraisers, and, if the appraisers do not agree on the value of the loss, the dispute is to be submitted to an umpire or arbitrator, whose decision will be final. Note, here, that this quite usual valuation dispute resolution provision, limits the owner's right (because of the rather narrow scope of judicial review) to contest in court, the umpire/arbitrator's decision valuing a loss under the policy. The point here is that the art owner should recognize that, if there might be serious disagreements over the value of a loss/damage claim, the owner is putting himself in the hands of a decision-maker from whose loss/valuation decision there may be limited effective appeal. — RDS*

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Valuing the Loss of Many Artworks: the Issue of "Blockage"

In October, 2012, Hurricane Sandy destroyed many things in the northeastern U.S., including an enormous amount of valuable art in New York City and environs. In a number of cases, the losses included large numbers of works by the same artist in the hands of dealers, estates and the artists, themselves. The insurance carriers were faced with a high volume of insurance loss claims for art created by one artist. The question facing the insurance carriers was how to value the losses in the hands of the insured owners. Many of the insurance policies provided for a valuation at "fair market value", some said "retail value" and other policies (for art dealers) provided for "consigned (consigned by the owner to the dealer) value plus `10%." The valuation question then became: if one destroyed painting had a "value" of $100,000, what to do when the same owner had twenty destroyed paintings by the same artist. Was the value of the loss twenty times $100,000? The owner certainly thought so, but some

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insurance carriers took the position that the owner of twenty paintings could not have sold all twenty, each for $100,000 on the date of the loss, and, further, the owners could only sell these works over an extended period of time (perhaps many years). Hence, some insurers argued that a "blockage discount" be applied to the value of the twenty paintings in the owners hands, otherwise owners would receive a "windfall", that is, more than the amount for which the art could have been sold on the date of the loss.

Usual Procedures at Inception of Property Insurance Policy

Often the insurer will request an inventory identifying the works to be insured as well as an existing appraisal or other valuation of the art before agreeing to issue a policy. There is usually little negotiation between owner and insurer over the value of the art, which value is then used to calculate the annual premium. Several weeks after the insurance broker/agent issues a binder, the actual insurance policy arrives, containing all policy terms, including an annual premium amount and dollar value of insurance coverage. The policy will also typically contain two additional provisions roughly worded as follows: (1) "Basis of Valuation of Loss in the event of claim" (The valuation will often state simply, "fair market value".), and (2) a paragraph entitled "Appraisal" or "Amount of Loss", which will usually provide, in the event of a claim, for the owner and insurer to each select their own appraiser and, if appraisers do not agree, for the appointment of a disinterested umpire/arbitrator to determine the amount of loss.

A major legal consequence will most likely follow from these simple, standard insurance policy procedures: The owner will be deemed to have agreed that an umpire or arbitrator will determine the owner's loss[1] and the determination will, as a practical matter, be subject to very limited review by a court.

The umpire/arbitrator will determine fair market value of the art at the date of loss by examining past public auction and private sales to arrive at the value at the date of loss. Then, as we will see below, the umpire/arbitrator may believe he has discretion to apply a "blockage discount" to the value, and so reduce the insurance payment by as much as 80% or more.

Silverstein's Claim Against the Insuror for Destroyed Photographs

In 2016 a United States District Court, in an action against XL Specialty Insurance Company, was asked to vacate an umpire's appraisal award in favor of the insurance company for photographs destroyed/damaged in October, 2012 during Hurricane Sandy. The insured, Bruce Silverstein Gallery, argued that the umpire, appointed pursuant to the XL insurance policy, acted outside the scope of his authority under the policy by not following the loss valuation words of the policy, and by applying a "blockage discount" to reduce the value of the Gallery insurance claim loss by 80%.

History of "Blockage" for Art Valuations

The concept of "blockage" for art sales first arose in the context of art valuations for estate tax purposes. Estate tax valuations must decide value as of a date certain, namely the date of death of the art owner. Since it would be unreasonable to calculate value based on a hypothetical one-time sale of a large number of works by the same artist, in effect, a bulk sale to a single buyer, three United States Tax Court decisions, starting in 1972 with the estate of David Smith, accepted the concept of "blockage" to discount the value for estate tax purposes of numerous works of art by the same artist. However, the blockage concept had never been applied to an art valuation for purposes of calculating a loss for an insurance claim.

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Silverstein had purchased 6,000 photographs by Frank Paulin in 2003, for $201,000, and in 2007, consigned 5,000 of the Paulin photographs to his Silverstein Gallery. The Gallery had an "All Risks Fine Art Dealers Floater" insurance policy. The "Basis of Valuation" provision in the Gallery policy [policy limit $17,500,000] provided that "consigned property shall be valued at the Agreed Net Consigned Value Plus 10%".

In 2013, Silverstein submitted a claim to XL insurance under the Gallery policy, asserting he had consigned his photographs to his Gallery and under the Gallery policy, the Gallery was entitled to receive from XL for the destroyed photographs, their net consignment value plus 10%, totaling $4,526,500.

The XL insurance policy contained the common appraisal provision (noted above) providing, for the appointment of a "disinterested umpire" to "determine the amount of the loss" in the event the appraisers for the insured and insurer failed to agree on the amount of the loss.

The Silverstein Umpire's Award Described below, Appears to Be Made in a "Free-Fire Zone" - Untethered to the Parties Shared Intent or Insurance Custom & Practice

The Silverstein/XL umpire addressed two major issues: (1) the explicit (loss) valuation provision of the Gallery policy, and (2) whether the umpire could apply a blockage discount to reduce the value of the loss.

The Gallery insurance policy (a dealer policy wherein the insured dealer was expected to be holding substantial amounts of consignor-owned art) provided that, for purpose of calculating loss, "consigned property shall be valued at the Agreed Net Consigned Value Plus 10%." Silverstein argued that the umpire was bound to accept as controlling the valuation provision of the insurance policy, to wit, "Net Consigned Value". However, XL claimed that since the consignment was by Silverstein and to his own Gallery, the umpire was free to reject Silverstein's Net Consigned Values plus 10% valuation and, instead, base the loss valuation on the "fair market value" of the destroyed photographs.

The umpire agreed with XL that, although there was no evidence of fraud or mistake on Silverstein's part, the absence of arms-length dealing between Silverstein and his Gallery in agreeing to a "consigned value", gave the umpire discretion to reach the umpire's own "fair market value" valuation, notwithstanding the explicit words of the policy (which said nothing at all about fair market value).

The Silverstein Umpire's Report

The umpire described the report of XL's appraiser, Victor Weiner, as follows:

> Based upon the price and sales data at the Gallery and at auction, as well as upon the "initial acquisition price of the Paulin photographs in 2003", Victor Weiner constructed a pricing structure ranging from $1,500 for small vintage photographs to $3,500 for larger vintage photographs, and from $1,500 to $3,000 for small later photographs to large later photographs. Using this pricing matrix, Victor Weiner placed a combined value of approximately $<u>2.9 million on the lost and damaged Paulins.</u>
>
> This $2.9 million valuation was then reduced by the blockage discount calculation performed by Jannette Barth ("Barth"). Barth did her blockage discount analysis by using the values that Victor Weiner placed upon the destroyed or damaged Paulins, and by thereafter estimating how long it would take to sell these Paulins on the basis of how many had sold during a recent period. In that regard, Barth, like Victor Weiner, focused

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> on the fact that there was a record volume of Paulin sales at the Gallery in 2008 and a "substantial decline" since then until 2012. Based upon the average number of sales during the four year period of 2009 through 2012, Barth projected how many years it would take to sell the lost or damaged Paulins. She then projected a future income stream associated with these future sales, applied an inflation factor to account for price increases, and then calculated the discounted present value of this income stream. Barth concluded that there should be blockage discount of approximately 80% resulting in a discounted value of the lost and damaged Paulins of approximately $590,700. (emphasis added)[2]

Silverstein's appraiser, Edward Yee, like Victor Weiner, also did a comparative market data analysis, to establish value, and concluded that a fair market value analysis of damaged/destroyed photographs supported Silverstein's insurance claim for $4,526,500 under the "Agreed Net Consigned Value Plus 10%" provision of the Gallery policy.

The Umpire's Report, continued:

The *Silverstein* umpire's award:

> … while Victor Weiner's valuation emphasizes the decline in sales between 2008 and 2012, minimizing the significance of the relatively high sales prices of individually sold photographs, Yee's appraisal conversely relies on the high individual sales price as the best reflection of market value, despite a decline in the volume of sales, which he regards as temporary. Finally, Yee declined to consider the application of a blockage discount regarding it as inapposite to the valuation of a loss under an insurance policy.[3]
>
> . . .
>
> Based upon the arguments of counsel, the testimony at the Hearing and an analysis of the respective written appraisals, the undersigned Umpire concludes that the valuation by XL insurance most accurately reflects the value of the loss on October 29, 2012. XL's valuation analysis takes into account a broad variety of factors, relying not only on the sales prices of realized sales at the Gallery as Silverstein's appraisal exclusively does, but also upon the declining trend of photographic sales at the Gallery and at auction, as well as historical factors such as the original price of the photographs purchased by Silverstein from Frank Paulin and the significantly lower value placed on the photographs by Silverstein in the 2007 consignment agreement with Frank Paulin.
>
> Finally, the undersigned Umpire rejects Silverstein's argument that, as a matter of law, a discount blockage reduction does not apply to the valuation of the art loss under the insurance policies at issue. The absence of language providing for its application is not determinative. Its application is consistent with USPAP Standard 6 which provides that when a large mass of property is to be valued as of a specific date, the appraiser is required to take into account that the value of the whole may be different from that of the individual parts. Where, as here, a large number of such items, consisting of more than 1200 photographs that were either lost or damaged, are to be valued as a particulate date, it makes perfect logical sense to assign a discounted present value to them based upon a future stream of income over an estimated length of time it would take these items to be sold. The discount blockage percentage arrived at by Jannette Barth reflects an

> appropriate methodology, is consistent with USPAP Standard 6 and avoids an unjustifiable windfall to the insured. [emphasis added][4]

As can be seen from the umpire's decision discussed above, the umpire ignored the loss valuation provisions of the policy ("Net Consigned Value Plus 10%") in favor of his own formulation "fair market value", on the grounds that, although there was no fraud or mistake, in consigning art to his gallery at his consigned values, Silverstein had "agreed with himself".

The umpire also decided that the umpire could apply a blockage discount to the loss valuation of the art, because it "makes perfect logical sense" to discount its present value, based on a future stream of income from sales over the period of time it would require to sell the art. And, the umpire continued: applying a discount blockage percentage reflects an "appropriate methodology" and "avoids an unjustifiable windfall to the insured."

Critique of Umpire's Silverstein Decision

The umpire's award says that blockage makes "perfect logical sense", and its application is in the interest of avoiding "an unjustifiable windfall". In raising this issue, the umpire seems not to consider *at all* that insurance policies are contracts between the insured and the insurer. (Indeed, the words "contract or the parties' "intent" do not appear anywhere in the umpire's award.) Yet, an insurance policy is a contract, and it is basic contract law that the meaning of a contract is derived from the shared intent of the contracting parties. Was it the parties' shared intent, when art was consigned by related parties (gallery owner/gallery), that the consignment values or methodology could be ignored? And, was it the shared intent of the parties that one party to the contract could not be advantaged by events occurring subsequent to the inception of the insurance policy? And what to think about a policy containing a fair market value at date-of-loss valuation provision, in an art market which has declined or increased from policy inception (when the premium was calculated) and down to the date of loss calculation? Compared to the art values used to calculate the premium at policy inception, the falling market event results in a "windfall" for the insurer and the rising market, results in a "windfall" for the insured. And in the circumstance of such "windfalls", is the shared intent of the parties as expressed in the valuation provisions of the policy to be ignored when such "windfalls" occur? Does the value which the insurer placed on the art for purposes of premium calculation suggest the parties' intent with respect to whether, the possibility of a windfall was contemplated (or, indeed, agreed upon) by the parties? And, when your 25 year-old roof blows away in a hurricane, do you receive from your insurer (assuming you do not have a full replacement value policy) the value of a new roof or the depreciated value of your actual roof, two-thirds beyond its useful life? It might well be expected that the parties contemplated the insured would receive the (the non-depreciated) cost of a new roof.

Critique of Award, continued:
Should Your Insuror Be Allowed to Value Your Loss According to the Price a Bulk Buyer Would Pay? Surely Not

By choosing to apply a blockage discount to an insurance loss valuation, an umpire, in effect, is deciding that the insurance loss should be determined by the price a bulk buyer of the art at the date of loss would be willing to pay. Of course, such a bulk buyer would properly take into account the time-value of money and market risk of his investment. Does the insured party to the insurance contract understand that the insurer, in the event of loss, intends to pay only what a bulk buyer would pay? And, the art owner should understand that the result of blockage discount for the owners' insurance claim, is that the

more art the owner has lost, the less the insurer will pay per item – the larger the volume of art lost, the greater the blockage discount for each piece.

In his award, the *Silverstein* umpire created, a "free-fire zone", quite unbounded by the shared intent of the parties, insurance industry custom and practice, or the explicit words of the policy. What made "perfect logical sense" to the *Silverstein* umpire, is interesting, but surely cannot be the applicable standard for interpreting the loss valuation provisions of an insurance contract.

"Agreed Value" Policies

Of course, all these difficult issues concerning which party to an insurance contract is receiving a "windfall" could be (and often are) avoided by agreement among the contracting parties, at policy inception, that the policy is an "agreed value policy", in effect, specifically scheduling values for each item of art. As explained in *Couch*, valued policies are enforced "to prevent insurers from receiving premiums on overvaluations but thereafter repudiating their contracts when it becomes in their interest to do so."[5] *Couch* continues, it is "recognized by all the cases" that, "under a valued policy", "the insurer may not go behind the policy and show that the insured's interest is worth less than the amount of the policy."[6] Thus, if a policy lists the value of a painting as $100,000, the insurer would be required to pay $100,000 in the event of a total loss, whether the painting had increased or declined in value since the date of policy issuance. "The valuation set forth in the policy is conclusive in the case of a total loss, absent fraud." Moreover, as *Couch* explains, "it is not necessary that the policy states that it is a valued policy, if there is anything in the policy which clearly indicates an intention on the part of the insurer to value the risk or loss, the policy is valued."[7]

Courts have rejected arguments by insurers seeking to renegotiate contract terms by characterizing them as a "windfall" to the insured. As explained in *A & M Steel Fireman's Fund*,

> [The insurer] argues that to allow [the insured] to recover a "windfall" is contrary to public policy. In essence, [insurer] now complains of a result which arose from its own drafting of the insurance contract. Webster's Third New International Dictionary (1961 Rev 1986), provides, … the following definition for "windfall:" "an unexpected or sudden gain or advantage." In this case, it is hard to see how [insurer] has gotten a "windfall" that was unexpected since the insurance contract clearly provides that no other costs shall be deducted in determining income. [Insured's] gain was clearly bargained for, so it cannot be said that it was "unexpected."[8]

Silverstein Blockage Discount Report (based, as it is, on Questionable Assumptions) Raises More Questions than Answers to such an Extent that the Whole Concept of a Blockage Discount in the Insurance Claim Context Becomes Doubtful

XL's appraiser, Victor Weiner, retained J.M. Barth to estimate blockage discounts to be applied in the Weiner appraisal.

The Barth blockage Report, dated January 2015, states, without more,

> "Upon review of the documents and data provided by the appraiser [Victor Weiner], it was *determined* [italics added] that a blockage discount should be applied to this valuation."[9]

One might well ask for the reasoning behind the appraiser's prescriptive decision that "a blockage discount should be applied to this valuation."

Jannette Barth, the author of the blockage Report, states that "the report draws on the article by Jannette M. Barth" "Determination of An Appropriate Level of Blockage Discount", published in *The Appraiser* in 1999. Thereafter, Barth apparently re-published more or less the same (non-peer-reviewed) article in several other publications through 2013. Barth cites no other published support by other experts for her blockage discount analysis, leaving unclear the existence of supporting authority from other appraisers and economists for insurance valuations.

Blockage Discount Critique, continued:

Barth sets out the steps used to estimate blockage – the first step, being a determination of the "base value" of the art. Then, Barth lists "factors" to be considered in the determination of "blockage discount and/or the base year valuation". These factors include the reputation of the artist, the "likelihood" of future markets for the artists work, and the "expected health of the art market and the general economy … Barth's list of factors in determining blockage seems to be the same factors she would consider in determining the "base value" of the art. Thus the question arises: are the same factors considered *twice*, once to determine "base value" and second, to determine the percent of blockage to reduce the very same "base value".

Blockage Discount Critique, continued: Other Art Available in the Market Should Not Reduce the Value of the Damaged Art

Barth also makes a troubling statement on the first page of her blockage Report, to wit:

> It should be further noted by the reader that because approximately 4,700 undamaged and unrestored Paulin prints remain in the [Silverstein Gallery], there are many more works available on the market than indicated by the works in the [Silverstein insurance] claim. Thus it is likely that the discounted value should be even lower than indicated by the blockage discounts [80%] calculated here.[10]

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Barth appears to be saying that the existence of a market "overhang" of similar works in dealer inventory, (perhaps not yet being offered in the market, but potentially for future sale) would require an increase (to something more than her Report's stated 80%) in the amount of blockage discount applied to the base valuation of the art being appraised. Does this mean that an accurate determination of blockage discount would involve an inquiry into third-party dealer inventories, as well as collector and artist holdings, on the theory that such a market "overhang", (that is, possible additions to supply) could further reduce Barth's estimate of the future sales of the art being valued? Assuming that such a difficult and extensive inquiry into inventories and collector's holdings is feasible, how is this overhang effect to be measured for purposes of calculating future sales volume. The measurement has the appearance of being so speculative as to be close to meaningless.

Blockage Discount Critique, continued:
The Owner's Remaining Art Should Not Reduce the
Value of the Damaged Art

But there is a more serious problem with concept of blockage for insurance claims beyond the difficulty or impracticality of measuring the third-party supply or "overhang" of available art for sale. Barth, in effect, is arguing in her Report, that the remaining amount of art the insured estate or collector has available for sale affects the value of the lost or damaged art. Thus, an estate/collector losing only a few works, but still left owning a lot of the artist's work would, based on this Barth analysis, be subject to a blockage discount applied to even the few lost works. In short, this blockage formulation puts the estate/collector more at risk for greater blockage discount, the larger the collection of subject artist works remaining after the loss.

Notwithstanding the High Bar for Overturning an Appraiser's Award,
the District Court's Decision Refusing to Vacate the Umpire's Award is Quite Wrong

Silverstein moved in District Court to vacate the umpire's loss appraisal award, arguing that the umpire acted outside the scope of his authority under the provisions of Silverstein's XL insurance policy arguing: (1) the Umpire did not value the photographs according to the "net consignment value" plus 10%, as required by the express provisions of Gallery insurance policy, (2) in effect, that the umpire "rewrote" the insurance policy by valuing the photographs as if they were being valued for future sales, and (3) by applying a blockage discount, which was not a valuation methodology included in the insurance policy.

In its decision declining to vacate the umpire's award, the District Court described the very high bar for overturning an umpire's appraisal award. "An appraisal award should be upheld unless there is clear and convincing evidence that the appraiser rendered the award in bad faith without sufficient thoroughness or based on bias or fraud" … "Mere error of law or fact is not a ground for rejecting the appraisal."[11]

In refusing to vacate the umpire's award of the value of the loss, the judge wrote:

> [the umpire] did not act outside the scope of his authority – he neither decided questions regarding the scope of the insurance coverage nor rewrote the insurance policy … The adoption of the blockage discount also fell squarely within [the umpire's] role as an appraiser because it was part of the valuation analysis. The decisions to apply a blockage discount and to select the appropriate discount amount are judgment calls within the purview of the appraiser just like the decisions whether to include, and how to account for, auction data and purchase price.[12]

The District Court writes that the adoption of blockage discount is a "judgment call" which "fell squarely within [the umpire's] role as an appraiser because (says the Court) it was part of the valuation analysis," … "just like" … "how to account for auction data". But adoption of a concept and methodology of blockage, (never before applied to an insurance valuation), is clearly *not* the same as routine tabulation of auction sales data.

The District Court concluded (incorrectly) that the umpire "… neither decided questions regarding the scope of the insurance coverage nor rewrote the insurance policy." The judge seems to have intended by her use of the words, "the scope of the insurance coverage", that the dispute between the insured and insurer decided by the umpire did not involve XL's denial of liability for loss, but merely the insurer's disagreement as to the amount or value of the loss. But where, as here, the insurer denies 80% of the value of the loss based on the application of blockage methodology unmentioned in the policy, there is little difference between a denial of liability and denial of 80% of the value of the loss. This is not simply a matter of deciding which art sales to tabulate and adding up the result. Whether denominated as a "valuation" issue or a "liability" issue, it requires a judge's interpretation and analysis of the insurance policy.

In short, the District Court (incorrectly) decided to view the umpire's decision as one simply valuing the loss rather than a decision going to the meaning or interpretation of the insurance contract, requiring the Court's construction of the insurance contract.[13]

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NOTES

[1] Most arbitration provisions, whereby parties agree to limit their rights to go to court, bind both sides. At least one insurer, added the following to an arbitration provision, to wit, "If we submit to an appraisal, we will still retain our rights to deny the claim." The result of this latter sentence seems to be that the insurer can, after having required its insured to arbitrate the value of the loss, deny the claim, and presumably its denial would not be subject to arbitration.

[2] Decision After Hearing. *In the Matter of the Application of Bruce Silverstein and Bruce Silverstein Gallery vs. XL Specialty Insurance Company*, August 10, 2015.

[3] *Id.* at 5.

[4] *Id.*

[5] Couch on Insurance 3d at §175:103.

[6] *Id.* §175:68.

[7] *Id.* §175:95.

[8] *A & M Steel Co. v Fireman's Fund Ins*. 1988 WL142030, *2 (Ohio Ct. App. 1988).

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[9] Blockage Discount Report: J.M. Barth, January 2015, at 1.

[10] *Id*. at 1.

[11] *Silverstein v. XL Specialty Insurance Co*., 15-CV-6818 (S.D.N.Y. July 21, 2016.)

[12] *Id.* at 10.

[13] *See Kawa v. Nationwide Mutual Fire Insurance Co.,* 174 Misc. 2d 407, 664 N.Y.S. 2d 430 (Supreme Court, Erie County, 1997), in which the court expressly declined to adopt the reasoning of a Florida court that "the extent of the claim does not constitute a coverage question."

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