

Spencer's Art Law Journal

Edited by Ronald D. Spencer

Editor's Note

This is Volume 5, Issue No. 1 of *Spencer's Art Law Journal*.

As noted in earlier volumes of this Journal, the legal structure we call art law (an amalgam of personal property law, contract, estate, tax and intellectual property law) supporting the acquisition, retention and disposition of fine art, often fits uneasily with art market custom and practice. The result is that 21st century art market participants are frequently unsure of their legal rights and obligations.

The two essays in this Spring/Summer Issue deal with selling your art by consignment. The first essay looks at the issues involved with consigning your art to a dealer or auction house. The second essay deals with making sure to get your art back if your consignee gallery goes bust.

Three times a year issues of this Journal will address legal questions of practical significance to collectors, dealers, scholars and the general art-minded public.

— RDS

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WHAT THEY NEVER TOLD YOU ABOUT CONSIGNING YOUR ART

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Gary D. Sesser and Judith Wallace

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Art consignment agreements are deceptively simple. This essay goes behind that simplicity to raise issues for art owners which are not fully addressed (or only imperfectly so) by the text of the usual agreement. Rescission by the auction house (undoing the sale long after the auction) is one of these issues. There are others. See below.
— RDS

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Consignments of art present special challenges for non-experts, especially when they are not accustomed to dealing with auction houses or art dealers. This is often the situation when someone inherits art or serves as executor of the estate, and may not be familiar with the artworks entrusted to their control or with the business of buying and selling art.

An heir or executor may have to liquidate assets reasonably quickly to meet the cash needs of an estate, and therefore may wish to enter into a consignment arrangement with a dealer or an auction house for the entire collection, to sell the art as the estate's agent. In these circumstances, there is a great deal at stake in the negotiation of a consignment agreement. This may not be fully appreciated by a consignor who is not experienced in the idiosyncrasies of art transactions.

Most consignors focus primarily on the minimum sale price and commission percentage, and possibly the allocation of costs such as insurance and photography of the art. However, there are a number of less obvious but important issues, including significant risks in the standard terms and conditions offered by the auction houses. The full impact of these terms may not be obvious to non-experts reading the agreements for the first time, but they have been the subject of a number of disputes, and can have significant financial impact for consignors.¹

1. Warranties Should Be Carefully Reviewed and Tailored to Your Actual Knowledge

Auction house consignment agreements generally contain warranties by the consignor about the consigned work of art. However, even if there is no written consignment agreement with an art merchant – whether auction house or art dealer – certain warranties are implied as a matter of law under the Uniform Commercial Code (UCC), which governs the sale of goods such as art, and the New York Arts and Cultural Affairs Law.

Title

Consignees expect consignors to warrant that they have good title and will transfer the work free from all liens or security interests. Section 2-312 of the UCC creates a warranty of title by sellers to buyers as a matter of law. The UCC does allow the parties to modify or waive that warranty, but it is extremely rare that consignors will do so, and auction houses would be particularly unlikely to do so. Under New York law, auction houses in New York City must make an unwaivable warranty of title to their auction purchasers.²

A consignor's good faith belief that he or she is conveying title is not sufficient to actually convey good title. In one recent dispute, the seller was unaware that "her" painting was actually stolen property. Unfortunately, her good faith in re-selling the artwork was of no help to her or her buyer. Under New York law, one cannot acquire

good title from a thief.³ The owner (from whom it had been stolen) could insist upon the return of the work by the party then in possession, regardless of the good faith of the possessor/seller.

Authenticity

Other warranties are less absolute. Warranties of authenticity are one example. Unless the consignor personally purchased directly from the artist, the consignor's knowledge of authenticity is likely based on the seller's representations, the provenance of the artwork (i.e., the history of its ownership and exhibition), or an expert's opinion. A representation regarding authenticity should be tailored to the consignor's knowledge, to minimize the risk of a warranty claim if it is later discovered that the work was misattributed to the artist. The consignor is most often not an expert, but the consignee may very well be an expert, or at least know how to contact the relevant expert. Accordingly, it is reasonable for a consignor to warrant that he or she has "no reason to believe" that the work is not by the named artist, or that the consignor relies on a particular expert's opinion for the attribution to the artist. Indeed, the major auction houses typically limit their warranties of authenticity in their auction conditions of sale, stating that they do not apply if the catalogue description was in accordance with the opinions of art scholars and experts *at the date of the sale* (so the auction buyer is out of luck if expert opinions change after the auction. Similarly, interpreting the New York Arts and Cultural Affairs Law, at least two judicial decisions have held that an "art merchant" selling to a non-merchant has not breached its warranty of authenticity if the merchant had a "reasonable basis in fact" for its warranty at the time of the sale.⁴ Whenever possible, consignors should seek the same standard for their warranty.

Provenance is often considered relevant to authenticity and value. Consignors should be careful with representations concerning provenance, especially a warranty that they are providing a "complete" provenance. There is no general agreement in the art world about what must be included, such as whether every prior owner is expected to be listed, or every dealer who was involved in a previous sale. The written statement of provenance most often does not provide a complete chain of title and possession from the artist to the current owner, and does not compensate for the fact that there is no title registry for personal property such as works of art. Nor is a "complete" provenance even possible in many cases, given the penchant for anonymity among many wealthy collectors, not to mention the confidentiality of private sales.⁵ And when it is not clear what should have been included, a dispute over whether the provenance was "complete" can be manufactured by a disappointed buyer who regrets a purchase.

In sum, whenever possible, consignors should warrant only those facts of which they have actual knowledge. Consignors should be clear and specific about the scope of these warranties, because they can provide the grounds to un-do a sale, even many years later, and a demand for refund of the purchase price.

2. "Rescission" Clauses Allow Auction Houses to Un-Wind Sales Years Later Without the Need to Prove in Court that Anything Is Actually Wrong with the Art

Standard auction house contracts (unlike most contracts with art dealers) invariably include broad "rescission" clauses. These provide the auction houses with authority to un-do an auction sale, refund the purchase price to the auction buyer, and demand a refund from the consignor if title or authenticity issues arise *even years after the auction*. The auction house rescission clauses generally provide the auction houses with "sole" authority to rescind if the auction sale "may" subject the auction house to liability, or even when they may damage the reputation of the auction house (which, as a practical matter, could be any claim). In short, the auction house can rescind without *proving* in court a breach of any warranty by the consignor, even when the consignor acted in good faith based on all information available at the time. Mere doubts about authenticity or negative rumors in the marketplace well after the sale could theoretically be a basis for rescission. In contrast, sales through private dealers generally can be un-done only if the breach of warranty claim is proven in court.

Allowing rescission by auction houses based on the mere possibility of liability is risky with respect to authenticity. Art sale contracts contain warranties relating to condition, title, and authenticity. Discrepancies in a work's condition should be apparent as soon as the buyer takes possession. Title disputes generally involve straightforward legal issues, although the facts may be complex. Questions about authenticity, however, can arise

years after the sale, whenever new information comes to light, when experts change their assessment of the work (perhaps even the same experts who initially supported an attribution), or when new forensic tools of analysis are developed. (Moreover, auction consignors are discouraged from challenging the determination that the auction house “may” face liability, because the consignment agreements generally provide that if the consignor fails to pay in response to a demand for rescission, the consignor is responsible for the auction house’s legal fees.)

Consignors to auction houses should seek to eliminate such open-ended clauses. Auction houses will be more flexible when the consignment is for a private sale rather than a public auction, since the terms for a public auction are published in the catalogue and cannot be tailored to each consignor. Auction houses will also be more flexible when they would like access to a particularly desirable work or collection. Ideally, consignors should limit rescission to representations by the consignor in the consignment contract, require immediate notice of a buyer’s rescission demand to the auction house, seek an opportunity to cure the purported problem, and seek to require “reasonable” determination or substitute an independent method for determining disputed facts in lieu of the auction house’s “sole” discretion that the auction house “may” face liability.

Ultimately, if consignors are troubled by the risk posed by auction house rescission clauses, and do not believe that selling through an auction house is significantly more likely to result in a sale and a higher selling price, they may prefer to work with an art dealer which (usually) does not insist on a rescission right that can be triggered by a mere claim or rumor (see above), before a problem with the art actually has been proven in court.

3. Guard Against Nonpayment, Because Title Will (Likely) Be Transferred to the Buyer Upon Delivery Even if the Buyer Has Not Paid for the Artwork

Consignors should be mindful that, under the Uniform Commercial Code,⁶ title generally transfers to a purchaser at the time artwork is physically delivered, regardless of whether the purchaser has paid in full. Furthermore, under the “entrustment” doctrine, whenever an owner hands over possession to a merchant in that kind of goods (such as an auction house or art dealer), a purchaser from that merchant acquires good title even if the merchant was not authorized to sell under those circumstances or at that price.⁷ Although the owner may well have a claim for breach of his contract against the merchant consignee, the owner does not have any right to cancel the sale and reclaim the artwork from the buyer.⁸

Moreover, a buyer could be located anywhere and the cost of a lawsuit against such a buyer could be prohibitive. Insurance companies have denied coverage in such cases, on the ground that the seller’s insurable interest ended upon delivery to the buyer, and in other cases on the ground that the loss was caused by breach of contract rather than physical loss of the artwork.⁹ To help guard against the risk of nonpayment, consignment agreements should provide that a consignee may not turn over *possession* or transfer title until the purchaser *has paid in full*, and that the consignee is responsible for the purchase price if it ignores this requirement.

4. Limit Discretion Afforded to Art Merchants

Consignors generally view art merchants as their agents. New York courts have repeatedly held that auction houses have a fiduciary duty to their consignors.¹⁰ However, this is less clear in practice. Fiduciary duties can be limited by contract. And, art merchants may sometimes regard the buyers as their real clients and primarily take their interests into account. There is a heightened potential for conflict of interest when the consignor is a one-time customer of the art merchant and the buyer is an important collector or dealer and a repeat buyer.

Consignors should carefully scrutinize any provisions that purport to grant an art merchant “sole discretion” to carry out any of its contractual responsibilities. Courts construing such language have taken the view that the auction house was properly acting on its own behalf and owed no duty to the consignor when it made a particular decision, notwithstanding the case law concerning the fiduciary duty of the auction house to its consignor. In one recent case, the auction house mailed the auction catalogue from a country that was in the middle of a postal strike. The catalogue was sent to potential buyers worldwide, and the auction was to be held in a country that was not experiencing a mail strike. Unsurprisingly, the catalogue did not reach the potential auction attendees on time. Some did not reach the potential buyers until after the auction. To make matters worse, the auction house failed to inform the consignor about the problem. Unfortunately for the consignor, this was not viewed as a

breach of contract by the court, in view of the broad discretion given to the auction house to determine the appropriate marketing for the auction and the fact that the catalogue was available on line. Unless the decision involves a technical issue on which the auction house has unique expertise, consignors should avoid giving the auction house “sole discretion” and require any consignee to make “reasonable determinations.” Finally, if the consignor expects the auction house to undertake certain specific marketing tasks, such as the inclusion of a color image of a work in a particular catalogue for a particular auction, these tasks should be spelled out as explicitly as possible in the agreement. If there is an auction house “marketing plan,” it should be incorporated into the consignment contract.

5. Specify Choice of Law

Consignors should also be sure that the contract specifies the applicable law that will govern the contract. The law governing art sales may vary significantly from state to state and from country to country. For example, in 2012 the New York legislature amended the New York Arts and Cultural Affairs Law¹¹ to enhance the rights of artists, artists’ estates, and artists’ heirs who consign works to art merchants. Such art merchants are deemed fiduciaries; art and proceeds from the sales of art are deemed trust property of the consignor; trust funds must be kept in segregated accounts separate from the art merchant’s general operating fund, and artists and their estates and heirs are entitled to attorneys’ fees in an action to enforce the law’s requirements.

Some consignors may find the amended New York law’s benefits so compelling that they will want to choose a consignee who is bound by New York law. Absent an explicit agreement to that effect, consignors should not assume any particular law applies based on their own location or their consignee’s. A consignee could have multiple locations, could be incorporated in another state, or could move, and may claim any of these as potential grounds for a different choice of law. Consignors therefore should *specify* the choice of law in the contract to avoid litigating a time-consuming and expensive issue later.

6. Limit Sub-Consignment

Consignors should always know the location of their artwork and who has possession of it. Consignment agreements, especially for a large estate with a number of objects, can run for years and art may be moved among various locations, or even as a series of consignments from one art dealer to others (whose identity may not be known to the consignor) over the course of several years.

Consignors therefore should limit the authority of an art dealer to re-consign artwork to another art merchant without written prior approval of the consignor. This is critical because of the so-called “entrustment doctrine” under the UCC, mentioned above, which provides that when an owner of property entrusts goods to a merchant, defined by the UCC as someone “who deals in goods of that kind”¹ (e.g., an art merchant), the merchant can transfer all of the owner’s rights -- even if the owner did not actually authorize the sale or the terms. Prohibiting sub-consignment by the art dealer ensures that the only one who can physically transfer the artwork is the dealer the consignor has personally selected. If the consignment is a large collection being consigned for sale over a number of years, the consignor should require annual inventories that specify the location and status (for example, on loan) of each work.

7. Know Your Consignee

Finally, and most critically, there is no substitute for knowledge and a level of comfort about the consignee. Written contracts can only memorialize that the parties are in agreement on the contract terms. However, a breach of contract claim is ultimately only as sound as the consignee. If a consignee improperly disposes of artwork and does not have the resources to back up his obligations, or is not inclined to honor his obligations, the consignor’s contractual rights will be cold comfort.

Consignors need to perform due diligence on their art dealer consignees. They should inquire with colleagues and other professionals they work with, including asking their lawyers to check court dockets for lawsuits against the art dealer. The process of negotiating a consignment agreement can provide valuable insight into the responsiveness of the proposed consignee. There is no substitute (legal or otherwise) for selecting a trustworthy and financially sound consignee with a solid commercial reputation.

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¹ At the opposite extreme are art transactions worth millions or tens of millions of dollars that are unaccompanied by any documentation spelling out the terms of the consignment. Many sales are documented only with a simple invoice, and consignment terms sometimes are not even discussed by the parties.

² Rules of the City of New York § 2-124.

³ *Solomon R. Guggenheim Fdn. v. Lubell*, 77 N.Y.2d 311 (1991).

⁴ *Dawson v. G. Malina, Inc.*, 463 F.Supp. 461 (S.D.N.Y. 1978). This warranty defense is not available in the sale of works produced in multiples. See NYACAL § 13.05.

⁵ See Gary D. Sesser, *Provenance: Important, Yes, But Often Incomplete and Often Enough, Wrong. What Consequence for a Sale?*, *Spencer's Art Law Journal*, May 30, 2013, available at <http://www.artnet.com/insights/spencers-art-law-journal/provenance-important-yes-but-often-incomplete.asp#.UtNh6ShpY20>

⁶ UCC § 2-401.

⁷ UCC § 2-403.

⁸ See, e.g., *Brown v. Mitchell-Innes & Nash, Inc.*, No. 06 Civ. 7871(PAC), 2009 WL 1108526 (S.D.N.Y. April 24, 2009) (owner had no claim against purchaser who bought painting from dealer in breach of consignment agreement).

⁹ See, e.g., *Zurich Am. Ins. Co. v. Felipe Grimberg Fine Art*, 324 Fed. Appx. 117, 2009 WL 1269439 (2d Cir. 2009); *Philadelphia Museum of Art v. AXA*, No. 2010 Civ. 587 (D. Md. July 6, 2011) (order granting insurer's motion to dismiss).

¹⁰ See, e.g., *Cristallina S.A. v. Christie, Manson & Woods Int'l, Inc.*, 117 A.D.2d 285 (1st Dep't 1986).

¹¹ New York Arts and Cultural Affairs Law § 12.01.

YES, YOU CAN LOSE OWNERSHIP OF YOUR ART. SIMPLY, CONSIGN TO A GALLERY WITHOUT GIVING PUBLIC NOTICE OF YOUR OWNERSHIP, AND UNDER U.S. LAW, THE GALLERY'S TRUSTEE IN BANKRUPTCY WILL HAVE A STRONG CLAIM TO YOUR ART.

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Aaron R. Cahn

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This essay addresses the, by-now-common-concern of an art owner's consigning to a gallery for sale and failing to file a Uniform Commercial Code financing statement giving public notice of the ownership/consignment. However, in a bit of good news for art owners, at least one court has recently decided that a trustee in bankruptcy for the gallery must prove that the gallery's creditors did not know the gallery was selling consigned art. — RDS

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Three years ago in these pages,¹ we discussed the perils that await a consignor of art to a gallery who fails to perfect his ownership interest by filing a Uniform Commercial Code financing statement with the appropriate jurisdiction. A recent case in the Salander-O'Reilly Gallery bankruptcy has brought this issue into vivid relief.

To briefly recap, the Uniform Commercial Code, in the interests of fulfilling its mission to ease the flow of goods in commerce, attempts to strike a balance between the interests of those who put goods into the stream of commerce and those who may deal with them along the way. In the same way that a lender secures his rights in collateral by filing a financing statement to give notice to other potential creditors that assets have been pledged as security for his loan and thus are not available to secure the borrower's obligations to other creditors, a consignor is well-advised to protect his ownership interest in the art he delivers to his consignee by filing the same financing statement form (the form in use by virtually all states has a box that can be checked to indicate whether the interest of the secured party is that of a consignor). Failing to do so may result in creditors of the consignee/dealer acquiring interests in the consigned goods superior to those of the consignor, and thus effectively *depriving the consignor of his ownership of the goods*.

*Jacobs v. Kraken Inv. Ltd. (In re Salander-O'Reilly Galleries, LLC).*² The bankruptcy judge overseeing the Salander Gallery case was faced with the exact situation described in our earlier essay: a consignor who had delivered a Botticelli painting to the Salander Gallery under a consignment agreement had failed to file a financing statement, and became locked in a battle with the bankruptcy trustee over the priority of interests in the painting. Because no financing statement had been filed, the court held that the consignor did not necessarily have a right to the return of his work, but at the same time gave the consignor a possible leg up in its quest.

When there is no financing statement filed, the court is left with the task of determining whether the arrangement between the owner/consignor and dealer is in fact a "consignment" as defined by the Uniform Commercial Code. The elements of Uniform Commercial Code consignment include a determination that the consignee is a merchant; that is, a person customarily engaged in selling goods of the type consigned (no question about that in the case of an art gallery); a finding that the goods are not "consumer goods" (a tougher call when the consignor is an individual collector, but not in this case, where the consignor was an investment firm); and most importantly, a requirement that the consignee "was not generally known by its creditors to be substantially engaged in selling the goods of others." The framers of the Code determined, as a matter of commercial policy, that if creditors dealing with a merchant know that he is regularly selling goods on consignment, then the need to file a publicly-available financing statement is eliminated since that would be largely duplicative of what most everyone involved already

knew. Only if the dealer's creditors would not be expected to know the nature of the dealer's business is a filing necessary to protect the consignor's interest.

Because the owner/consignor in this case failed to take the few minutes and few dollars it would have cost to file a financing statement, the owner will now be faced with an evidentiary hearing on the issue of whether the elements of a UCC consignment had been met. But there is one relative bright spot for the consignor: although courts are split on the issue, the *Salander* court decided (without much discussion, but generally referencing the principle that the party arguing the affirmative side of a proposition has the burden of proof as to that proposition) that the burden would be on the trustee to prove the elements of the consignment; that is, the trustee would have to prove that the gallery's creditors did not know that the gallery was selling consigned goods.

In our earlier essay in the Spring 2011 issue of the Journal, we identified this burden as belonging to the owner/consignor, and there are indeed cases that have placed the burden there. In the *Salander* case, the court went the opposite way. So here the trustee will be faced with the task of assembling all the Salander Gallery's creditors (consignors who are owed the proceeds of sales, banks, utility companies and incidental creditors (such as fast-food vendors) and allowing the court to determine how many of those creditors would be expected to know that the gallery was mostly selling consigned works. Whatever the outcome, the owner/consignor, by failing to take a simple step to protect its rights, has already lost a significant battle. Whether or not the owner/consignor also loses the war, this contest starkly illustrates the ease by which any litigation could have been avoided in the first place.

New Developments

In recent months, some commentators have suggested that filing a financing statement is less of a cure than it seems, because the elements of a consignment as defined by the Commercial Code include the "not generally known" element, and therefore if the proof shows that a majority of creditors were aware that the gallery was selling primarily on consignment, the financing statement may well be ineffective or unnecessary. But the "not generally known" prong is not as easily brushed aside as these commentators make it appear. While it is undoubtedly true that a significant majority of people *involved in the art world* know that most dealers sell substantially if not exclusively on consignment, the same cannot be said for those whose only contact with the art world may be that a gallery is a customer of theirs. Should companies that sell office supplies or deliver fast food or supply electricity, bottled water or telephone service to a gallery be chargeable with the way in which a gallery conducts its business? If not, and if, as is often the case, such "non-art" businesses make up the bulk of a gallery's creditors (by number of creditors, not by amount of debt), then it may well be that a seller's consignment agreement may be held to be one that meets the Commercial Code definition.

Of course, the most striking aspect of this line of commentary is that it fails to appreciate that filing a financing statement is a no-lose proposition. If it turns out that a majority of a dealer's creditors knew that the dealer was selling on consignment, then perfection by filing would not be necessary, and the worst case scenario for the consignor would be that he spent a small amount of money to have a financing statement prepared and filed that turned out not to be necessary. But if the "not generally known" element is satisfied, and the consignor hasn't filed, he will have lost the preferred position of a secured creditor. Therefore, filing takes away any incentive a bankruptcy trustee or other party would otherwise have to litigate the "not generally known" element.

The other limiting element of a Commercial Code consignment is that the works delivered to the dealer must not be "consumer goods." Beyond reciting the standard definition that consumer goods are those which are acquired for "personal, family or household purposes," the Code offers no guidance. But uncertainty over whether a work of art consigned to a dealer will ultimately be determined to be a consumer good is not a reason not to file. As pointed out above in connection with the "not generally known" element, the worst case scenario is that a filing will turn out not to be effective if the consigned works are determined to be consumer goods. But if they are not so determined – and there are many people in the art world who collect, buy and sell on a regular enough basis that their holdings may be determined not to be consumer goods – then the failure to file can have grave consequences indeed.

In fairness, many of the commentaries that play down the effectiveness of filing financing statements do so in the context of a call for new legislation that would remove many of the uncertainties associated with the current system - certainly a worthy goal. But until new legislation happens, filing is the best way to guard against an unanticipated loss of secured party status, and give a consignor maximum peace of mind.

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¹ Aaron R. Cahn, *A Funny Thing Happened on the Way to the Gallery – A Bankruptcy Fable (Or Not)*; *Spencer's Art Law Journal*, Vol. 2, No. 1 (Spring 2011).

² 506 B.R. 600; 2014 Bankr. LEXIS 1101; 59 Bankr. Ct. Dec. 82 (decided March 21, 2014).

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