The Perils of Consigning

Protecting your stake in an artwork may not be as simple as it seems, especially when you consign it to a gallery

By Thomas and Charles Danziger

According to one of our most faithful readers, we spend too much time gallivanting about at gallery openings and attending fancy dinners with art collectors. Our mother may be right, but our legal practice also has a serious side: On occasion, we are called upon to deliver especially bad news regarding our clients' art-world investments. And consignments of art produce more bad news than any other area of our firm's practice.

Put simply, most people are completely ignorant of the legal risks involved in consigning a work of art, whether to a gallery or a private dealer. Even savvy clients who insist on a proper consignment agreement often don't realize that additional steps are required to protect their legal rights. Without this protection, says attorney Dean Nicyper, an expert in this area, "the collector runs a real risk of losing his work to creditors in the event the consignee goes belly up."

Typically, going "belly up" means that a gallery declares bankruptcy, as happened in the recent case of Berry-Hill Galleries in New York. But the same principle could apply in other situations, as when creditors go after the assets of someone who defrauds them. This famously occurred with fugitive art dealer Michel Cohen (who could not be reached for comment—at least not by us). Cohen "sold" the same works to different unsuspecting buyers, costing them tens of millions of dollars in the process. The result was an unmitigated disaster, says Nicyper, with numerous creditors trying to collect millions of dollars from a limited pool of assets.

In order to understand the rights of a consignor, one must first understand the legal definition of *consignment* under the Uniform Commercial Code, the unified body of law, adopted in all states, that governs commercial transactions. In broad terms, Article 9 of the ucc provides that a consignment occurs when a person delivers goods valued at $1,000 or more to a merchant (in our practice, usually an art dealer) who deals in similar goods for the purpose of sale. Typically, the consignor intends to own the art until the moment it is sold to the dealer's client.

Although the ucc definition is easily stated, much legal commentary has focused on whether particular transactions fall within its parameters. For instance, is the consignee (the party to whom the work is consigned) technically a "merchant" under the ucc? Is the purpose of the transaction to sell the work? Interestingly, auctioneers are specifically excluded from the definition of "merchant" under Article 9. And if a work is given to a merchant for a purpose other than to sell it—for instance, to obtain an appraisal—it would not constitute a consignment under Article 9, and other rules might apply.

So what can smart consignors do to inform would-be creditors—and the world—that they actually own a particular painting hanging in a gallery? What can they do to ensure that their painting is not used to satisfy the gallery's debts, and how can they avoid losing their artwork altogether in the

event that the gallery declares bankruptcy?

The short answer is to run a ucc lien search on the gallery and to file a ucc-1 financing statement—both relatively simple and inexpensive processes. A ucc lien search will reveal the names and addresses of other creditors of record, if any, and the extent of their financial interests. The search may show whether a gallery is skating on thin ice (for instance, if it has an unusually high level of debt)—information that itself may make a consignor reconsider the deal. The search may also indicate whether other creditors have liens that might conflict with the intended consignment. This could occur if, say, a creditor has taken a lien on "all inventory of the gallery, wherever located."

With the ucc lien search in hand, the consignor then files a ucc-1 financing statement, which describes the consigned work and puts the world on notice that the consignor is its legal owner. According to art law expert John Cahill, "The filing is usually made with the secretary of state in the state where the gallery is located," and must be made within 20 days after delivery of the consigned work.

The filing is effective for five years, and may be renewed for successive five-year periods by filing additional statements. If a consignment agreement is signed by the dealer, his or her signature is no longer required on the financing statement. It is important that the ucc-1 contain the *exact* name of the dealer or gallery, because a misspelling may result in an incorrect filing by the state. If the filing is made properly and in a timely fashion, the consignor's ownership interest will supersede any claims by the gallery's other creditors.

As readers of this column will recall, we always advise clients to obtain written consignment agreements with galleries, which form the contractual basis of the consignment. In addition to addressing such basic issues as the duration of the consignment, the price at which the gallery may sell the work and the amount of the commission, the agreement should clearly state that the consignor retains a security interest in the consigned work.

Recent cases in this area have affirmed the principle that, in the absence of a properly filed ucc-1, a consignor may lose his property if the gallery runs into financial trouble. For instance, in the 2003 New York bankruptcy case *In re: Morgansen's,* the court overruled the objections of consignors who did not want the goods they had consigned to a collectibles and furniture shop in Southampton auctioned off to satisfy the shop's creditors. The consignors had authorized Morgansen's to sell their goods by private sales or auctions and to pay the consignors the net proceeds of the sale, minus a commission, although they had not made a ucc-1 filing to protect their interests.

Holding in favor of the creditors, the *Morgansen's* court observed: "This may strike the consignors as grossly unfair, but that is the balance that the State of New York reached among competing parties in interest. The law is painfully clear—anybody who delivers goods with a 'right of return' to a merchant

who sells them under its own name is at risk that the merchant may file for bankruptcy relief, and the trustee will liquidate the goods for the benefit of the creditors."

Although filing a ucc-1 financing statement is the most common way for a consignor to "perfect" his security interest in art (that is, to make certain he preserves his rights against other creditors), the ucc specifies other ways to perfect this interest, such as taking physical possession of the work.

What happens if a consignor has not filed a ucc financing statement or otherwise perfected his interest in a work? In the worst case, Cahill says, "the artwork would be thrown into the pool of the gallery's other assets, and the consignor would be treated as a general creditor, in the same position as, say, the electric company." Secured creditors (those with perfected security interests) would have first crack at these assets, and their claims would be satisfied in full before general creditors recover anything from the bankrupt entity. Clearly, then, it is better to be a secured creditor than an unsecured one.

Nonetheless, even if a consignor has not filed a ucc-1 and a gallery does go bankrupt, all is not necessarily lost. For instance, if the collector could demonstrate that the dealer was "generally known by its creditors to be substantially engaged in selling the goods of others," the creditors would not have a right to take the consigned work under Article 9, although they might have rights under other provisions of the ucc.

However, "generally known" is a tough standard to meet, in part because it is so vague. For instance, if a jewelry store goes bankrupt, other jewelers might know that the store was substantially engaged in selling the goods of others, but creditors such as the gallery's phone company might not. And most courts have insisted that an actual majority of creditors be aware that the dealer was dealing primarily in consigned goods.

The 1998 federal case *Berk* v. *State Bank of India* illustrates the tension between the rights of a consignor and those of creditors. The plaintiff, Sheila Berk, sued for the return of jewelry she had consigned to a Madison Avenue jewelry store that went bankrupt. She had not filed a financing statement but did sign an agreement with the store upon making the consignment that specifically stated: Title to her merchandise would remain with her; delivery of the jewelry to the store was for inspection only; the store must return the jewelry to her on demand; and the store had no right to transfer the jewelry without her written permission. Nevertheless, the court agreed with State Bank of India, the creditor of the bankrupt jewelry store, that the bank's right to Berk's jewelry was superior to hers.

The *Berk* court found that there was insufficient evidence to support Berk's claim that the store was "generally known" by creditors to be selling the goods of others, and that the bank therefore had no claim to her jewelry. Moreover, the court was not swayed by the fact that as many as 151 out of 481 pieces of jewelry seized from the shop had been on consignment: "That a

judgment debtor is discovered to have a substantial amount of consigned jewelry in its possession at the time of debt collection reveals little about whether its creditors generally knew that it was engaged in selling consigned goods and even less about whether those creditors extended credit in the reasonable belief that the debtor owned and would continue to own its inventory."

Filing a financing statement would probably have simplified life for Jerry Ganz, the plaintiff in *Ganz* v. *Sotheby's Financial Services,* which involved the notorious dealer Michel Cohen. Ganz, a collector, gave physical possession of his Chagall painting *Soleil couchant à Saint-Paul* to Cohen, who in turn transferred the picture to Sotheby's as collateral for a loan. Cohen, who turned out to be far from the upstanding dealer he was thought to be, then defaulted on the loan and fled the country. Sotheby's and Ganz each claimed to have a superior interest in the painting.

Ganz had not filed a financing statement, and the New York court observed that his delivery of the painting to Cohen, even on consignment, did not create a security interest. The upshot was that the court refused to grant summary judgment to any party and instead determined that Ganz bore the burden of proving as a factual matter that Cohen was generally known by his creditors to be substantially engaged in selling the goods of others. The case was settled prior to trial.

As these cases demonstrate, simply proving one's initial ownership of a work of art is not enough to shield it from being claimed by someone else. By following a few simple steps before consigning a piece, a savvy owner can save himself much trouble and expense. And that's something any mother would appreciate.