In Lien Times

Art can be valuable collateral, but pitfalls await lenders and collectors alike.

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SINCE ART AND MONEY go together like peanut butter and jelly, it's little wonder that many banks (including a number of our firm's institutional clients) have shown an increasing appetite for making loans secured by art. So Anton's call to us came as not surprise.

Anton was a hungry banker cooking up a plan to launch an art lending business. He had read about loans to Wall Streeters like Michael Steinhardt and Nelson Peltz, secured with blue-chip works of art-as well as to such institutions as New York's Metropolitan Opera, which reportedly pledged two murals in connection with a loan from JPMorgan Chase. Anton was licking his chops over the prospect of charging hefty fees and handsome interest rates. How could his plan go sour?

We told Anton that some commercial lenders have indeed done well in this area, with lower rates of default on art loans compared with other asset classes. Art loans also appeal to collectors, who can often borrow more cheaply against their art than against other assets. Moreover, art-backed borrowing is an attractive alternative to selling works, which may involve high capital gains taxes (the federal rate goes up to 28 percent on art and antiques), not to mention considerable transaction costs.

But we didn't want to sugarcoat the difficulties involved in lending against art, so we gave Anton some practical advice to chew on. First, and perhaps most important, banks in this area go to great lengths to confirm that would-be borrowers are beyond reproach in terms of not only credit history but also character. Many art loans never get past this initial stage.

Assuming the borrower passes muster, the bank then goes about establishing that the art to be pledged is authentic. Whereas a lender making a loan secured by a building won't often find that the real estate is not "real." Banks lending against art may discover that their loans are secured (as it were) by fakes. To avoid this, lenders typically rely on auction house specialists, a handful of recognized independent appraisers, and, where needed, other experts in the field.

Lenders usually want an authentication done specifically in connection with the loan, even if a work was recently purchased through a major auction house or was authenticated in the past by an expert. The borrower customarily pays for this process, whether or not the loan actually closes.

Next, the bank establishes the value of the collateral. Most institutional lenders are unwilling to make a loan for more than about 50 percent of an artwork's appraised value – but even here, an unsophisticated underwriter can get into the soup if he relies on a half-baked appraisal. We know of at least one banker who won't accept valuations given by even the major auction houses because he believes they face a potential conflict of interest: a duty to provide an accurate appraisal versus an incentive to please a collector-who may be an important client-with a high one.

Then comes the sticky part of the underwriting process: establishing that the would-be borrower actually owns the art. We routinely review purchase invoices, deeds of gift, wills, and other supporting documentation, and we check independent databases, such as the Art Loss Register, to see whether a work has been reported stolen. We also run a Uniform Commercial Code (UCC) lien search that allows us to search states' reports to reports to determine whether the proposed collateral has any liens filed against it. Still, unexpected problems involving title and ownership can arise. Many people don't realize that UCC filings contain a cornucopia of fascinating information – such as an artwork's true owner, if it has been consigned to a gallery – that is then published on states' Web sites. (In fact, some of our savvier dealer clients use UCC filings to locate desirable works and motivated sellers.)

The UCC and related case law occasionally produce ulcers for the unwary when creditors like banks square off against consignors of art to galleries. A consignor who fails to make a timely UCC filing risks losing a work altogether if he hands the piece over to a gallery that is subject to a blanket lien, since the lender could use the consignor's art to satisfy an earlier debt. This was essentially what happened in the 2003 U.S. bankruptcy court case *In re: Morgansen's Ltd*., which involved a shop in New York that sold antiques, jewelry, and collectibles, mostly on consignment. After the shop went bankrupt, the court found that the consigned goods were subject to the claims of the shop's creditors.

Banks are likewise cautious when it comes to accepting art as collateral in loans to galleries. Under the UCC, a lender may lose its security interest if a pledged artwork is sold by the gallery (the lender would still have a claim on the proceeds, but they may be spent before the lender can recoup them). Memories of lending disasters past involving art collectors, such as Ralph Esmerian, or dealers like Larry Salander – both now in prison – give some bankers heartburn. So some lenders have no thirst for making art loans to galleries. OR if they do make such a loan, they insist that the pledged works be held in a third-party storage facility.

Several American banks, Emigrant Bank Fine Art Finance and U.S. Trust among them, don't generally take physical possession of a work owned by individuals so long as the art is in the U.S. and the location is agreed upon in writing. But lenders occasionally find themselves in a pickle when trying to gain access to an artwork. We recently saw a case in which the borrower's wife refused to let a bank representative into an apartment the couple co-owned, even though her husband had given the bank right of entry. To be prudent, we require a spouse to agree in writing to grant access to the home if the borrower defaults; similarly, if a work is held in storage, we have an agreement on file confirming that the bank can get into the warehouse.

Another critical area of concern for lenders is the exit strategy if a loan should go bad, especially since art is a fundamentally liquid asset. Even a great picture may fail to sell on a given day at auction, and if a work is thus "burned," the lender may be saddled with an unsaleable asset. To minimize market risk, banks generally don't lend against a single work but instead insist on several pieces – ideally in different genres – as collateral. In the most famous recent case of an art loan going spectacularly south, celebrity photographer Annie Leibovitz borrowed $24 million from Art Capital Group, which reportedly took a security interest in, among other things, Leibovitz's Greenwich Village town houses, a country home, and the copyright to every photograph she had taken or ever would take. In 2009 Art Capital Group sued her for breaching the terms of their loan agreement; the parties eventually settled.

Anton now saw that the art-loan business is no picnic, so we told him about the cherry on top for smart art underwriters: Every borrower not only pledges artwork as collateral but also gives an unconditional personal guaranty on the loan, granting full recourse against all the borrower's unencumbered assets. Anton digested what we told him and then had an epiphany: "Art loans are really personal loans secured by art as additional collateral!" Exactly, which is why the borrower's character is always critical to a successful loan. When done correctly, art lending can be a sweet transaction for both bank and borrower. When done wrong, however, it's a recipe for disaster.

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Some facts have been altered for reasons of client confidentiality or, in some cases, created out of whole cloth. Nothing in this article is intended to provide specific legal advice. "In Lien Times", originally appeared in the April 2012 issue of **Art+Auction.**