

The art of lending on art

Traditional issues, like credit concentrations, take on new meanings

If a client brought Van Gogh's "The Sea At Sainte Marie" to you as collateral, would you have the slightest idea what to do with it? Or even know if you should?

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As is the case with many products offered in the world of private banking, art secured loans are handled in a highly confidential manner, even, perhaps, with a dose of intrigue. Boutique finance firms and some of the world's largest private banks have long offered their elite clients loans secured by valuable works of art. It is only in recent years, however, that the value of art has often risen faster than the value of more conventional assets, including real estate. Currently estimated to be a market in the range of \$7 billion, the growth of art financing has coincided with the increased accumulation by high-net-worth individuals of hundreds of millions of dollars in art collections. More bankers are looking to those art collections as potential asset pools to secure significant and often complex loans.

Why borrow (and lend) on art?

The purposes of art loans are as varied as the art itself. Some borrowers seek to line up financing to acquire yet more art. Other borrowers seek to "cash in" on the increased value of their artwork without having to sell it and pay capital gains taxes. In other cases, borrowers seek working capital to expand the core business that generated the wealth that allowed them to build significant collections.

One Miami developer, Martin Margulies, recently obtained an \$80 million loan from U.S. Trust, with the loan backed by his fine art collection in order to fund the construction of a high-end condo project. (Our firm helped the bank frame the deal.) By doing so, he saved in transaction costs and reduced the disbursement complexities typically associated with construction loans. Whatever the purpose, savvy collectors are using the beautiful items hanging on their walls and lining their hallways in the same manner that they use other valuable assets such as securities or real estate. Bankers desiring to keep more of a client's business are having to consider art loans as part of their product offerings.

It should be readily apparent that loaning millions of dollars against an asset (or assets) that is highly mobile, easily destroyed, and somewhat illiquid presents a number of business and legal issues that require careful consideration. (Indeed, another issue is that the title to work may be suspect.) This article will focus on certain fundamental issues involved in structuring and documenting transactions involving loans secured by fine art located within the U.S. The focus will be on loans to individuals and entities who buy art for collection purposes, and not loans to persons or entities who are "in the business of" buying and selling art, such as art dealers and galleries.

Where did you purchase that Picasso?

Unlike other forms of collateral, such as real estate or motor vehicles, title to art is not evidenced by a uniform system of titling and there is no official central registry where one might trace the origins of the art.

Sometimes the art's origin and source--in the field, this is called "provenance"--is widely known, as is the case for extremely valuable pieces held by well-known collectors. In the great majority of cases, however, "title" to or ownership of the art will be evidenced merely by a bill of sale, receipt, will, trust, or some other documentation that is not as formal in nature as one might expect for an asset worth so much money.

Lenders must cautiously navigate this potential uncertainty. Experienced lenders view each piece on its own merits and evaluate its ownership based on a totality of the circumstances. In addition, art collectors seeking art-backed loans are usually valuable clients of the bank in other areas, meaning the client has built up a significant level of trust with the bank based on deposit, credit, or investment relationships. That trust is buttressed with very specific representations, warranties, and covenants of the borrower in the loan documents relating to, among other things, title and ownership.

After all is considered and analyzed, there is no infallible litmus test to determine whether a borrower has good title to a particular piece of art. Nonetheless, provenance is a key issue to art financing, as a borrower is able to encumber only those rights it has, or has the power to transfer, in and to the art.

Secure my Cézanne, please

The creation and perfection of a security interest in fine art located in the U.S. is primarily governed by Article 9 of the Uniform Commercial Code (UCC), as in effect in the applicable jurisdiction. There may also be other state laws that deal specifically with art, art dealers, or auction houses. For a security interest to be enforceable against the debtor with respect to specific collateral, generally three things must occur: the debtor must receive value; the debtor must have rights in the collateral or the power to transfer rights to a secured party; and the debtor must execute a security agreement containing certain key provisions.

The security agreement should describe the art with as much specificity as possible, including, for example, the name of the artist and the title (if there is one), date (if known), dimensions, and a brief description of the piece.

Most lenders will obtain an independent appraisal of the art, primarily for valuation purposes. If such an appraisal exists, it is good practice to use the description used by the appraiser as your starting point.

In lending, perfection is not in the eye of the beholder

In addition to obtaining a proper security agreement, the lender must ensure that its security interest is perfected. Perfection is crucial because, without it, another secured creditor, a judgment creditor, or a bona fide purchaser of the art may take priority over, or free from, the lender's security interest. Additionally, failure to perfect the security interest will result in the debt being treated in a bankruptcy proceeding as unsecured, notwithstanding an ironclad security agreement. The result, of course, is that the purported secured creditor would join the ranks of the other unsecured creditors--a rather precarious position in most bankruptcies.

An important first step for any secured lender is to conduct a UCC search under the name of the art owner (typically the borrower or a guarantor) to determine if the art has been previously encumbered. The lender should also evaluate, as an initial matter, the classification of the art under the UCC. Art collateral is typically considered to be "goods" under the UCC, although it is conceivable that a large artwork, such as a sculpture or installation, be deemed to be a fixture. And if the borrower is in the business of selling art, the art would likely be considered inventory.

Assuming that the art is a good, the lender may perfect its security interest in the collateral either by filing a financing statement relating to that art or by taking possession of it. Most lenders are not equipped to take possession of valuable art. While the lender may use specialized storage facilities to take possession on the lender's behalf, as a practical matter the art owner will not want to give up possession while the loan is in place.

Assuming the method of perfection to be the filing of a financing statement, the secured lender must ensure that the financing statement is in proper form. Lenders should exercise care to use the correct name for the debtor and an adequate collateral description. Using the same collateral description used in the security agreement would suffice. There are situations, however, in which the borrower may specifically request, typically for confidentiality purposes, that the art not be described in detail in the financing statement. In such cases, there are ways to adequately describe the collateral without actually listing the artwork.

Lenders must also ensure that the financing statement is filed in the filing office where the debtor is located, which, in the case of an individual, is the state of the individual's principal residence. As many high-net-worth borrowers have multiple homes in multiple jurisdictions, it is often difficult to determine the individual's principal residence. In such cases, it is advisable to file financing statements in multiple jurisdictions.

You want to do what with that Warhol?

Knowledgeable art lenders impose a number of requirements on their borrowers to address or minimize some of the risks inherent in art lending. Below are some typical requirements lenders should consider in any loan secured by art. While these requirements often generate significant pushback from sophisticated borrowers, lenders should resist eliminating or substantially watering them down.

1. Change of location. Art owners want the ability to enjoy their art and lend it to museums and galleries. Lenders,

however, should insist that the borrower identify specific locations at which the borrower will maintain the art. Then they should ensure that the borrower will obtain the lender's consent prior to moving the art from these locations. Finally, the lender should cause any third party temporarily having possession of the art (such as a storage facility, an art gallery, or a museum) to enter into agreements with the lender to address potential issues.

The issue of an understanding regarding the art's location is significant for purposes of determining governing law issues; to ensure that the art is not taken to a foreign jurisdiction that would permit the borrower to easily sell or further encumber the art free of the lender's security interest; and, from a practical perspective, to be able to verify that the art is located where it is supposed to be and remains in good condition.

2. Loan-to-value ratios. Most art lenders will lend only against a percentage of the fair market value of the art supporting the loan. The percentage varies, but a typical limit is a 50% loan-to-value ratio. The ratio is not only used to establish the initial loan amount, but also as a permanent borrowing base, in that the borrower will be required to either pay down the loan or encumber additional art (or other collateral) if the ratio ever exceeds the maximum allowed.

The lender should value the art for purposes of such calculations based on appraisals of the art, which are typically conducted annually and even more often if the lender determines that there is a reason to do so. The lender may also want to impose restrictions on the percentage of the aggregate collection value attributable to a particular artist. Such a requirement addresses the issue of over-concentration of a collection in the artwork of one artist and the risks inherent in such a scenario.

Like with any asset class, diversification of risk and proper allocation of that risk both in respect of a particular loan, and within the lender's total loan portfolio, is prudent.

3. Insurance requirements. As with most other types of collateral, the lender should require that the art be insured and that the lender is named a loss payee on the relevant insurance policy. Lenders should be comfortable with the company issuing the policy and the terms and conditions of the policy, including coverage limits.

Not for novices

Art ownership is as much an emotional connection as it is a financial investment. But while that statement is undoubtedly true, lenders who deal with art as collateral must view the art through a cold and objective lens.

Starting with UCC searches and filings and ending with the execution and delivery of complex loan documents that describe lending mechanics, grants of security interests, and a myriad of restrictions placed on the borrower and the art, lending against art is not for the inexperienced.

Prudent art lenders should be well aware of the nuances of the art world, understand the potential weaknesses involved in taking art as collateral, and be able to convince the demanding client, who is accustomed to utilizing significant leverage, why it is important to impose certain restrictions on their art collections in ways that may seem intrusive or controlling.

This article has addressed a few of those issues, but each loan will require the lender to tailor the restrictions to the borrower and art collection with which it is dealing.

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Both attorneys are headquartered in the firm's Miami office and have been involved in a number of significant art loans. Several transactions involved amounts in excess of \$150 million where the collateral included pieces by some of the world's most renowned artists, including Cézanne, Hirst, Koons, Matisse, Picasso, Warhol, and many others.

[This article was posted on May 11, 2012, on the website of ABA Banking Journal, www.ababj.com.]