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INVESTING IN AN ART FUND?

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With recent art prices reaching record highs across nearly every collecting genre, medium and period and art being dubbed "the new asset class," art investment funds have returned to the marketplace as viable alternative investments. Still an emerging industry, there are now an estimated fifty art funds in the United States and new global sectors such as the Middle East, Asia and Russia ranging in stage of development from capital raising to buying fund assets. Investors in these art funds, who are often individual private collectors with an affinity toward and considerable experience with art, are increasingly viewing art as no longer purely a cultural pursuit but as serious monetary investments as well.

Given the basic strategy of any investment to "buy low and sell high," with art being no exception, the idea of investing in an art investment fund might seem easy – funds conduct due diligence on certain sectors of the art market, acquire undervalued artworks at low price points, sell their artwork when valuations have peaked and thus succeed in a classic well-tested investment strategy.

This article will focus on a paramount issue in art fund investing: namely, how art funds will manage the core risk of defective legal title to the art that the fund buys and sells, especially when the fund publicly exposes the art through publication and exhibition to enhance its value proposition but at the same time unavoidably exposes it to potential claims. An art fund's goal and fiduciary duty toward its investors is to secure returns according to best practices and efforts. However, an art fund's total loss of one of its artwork investments, or even partial loss through settlement or expenses and costs expended in litigation defense, because of a title dispute on an artwork could significantly diminish the fund's investment returns for many years.

A Primer on the Art Market

The art market now exceeds $50B in annual transactions globally, making it the largest lawful industry in the world that is essentially unregulated. The unregulated nature of the art industry engenders a lack of transactional transparency and, in turn, high risks of ownership disputes or what is otherwise called defective legal title. Defective art title risks are compounded by the long-standing practice in art transactions of withholding seller and buyer identities to protect their privacy as well as dealers' sources and pricing structures. Poignantly, Steven Spielberg, a known Norman Rockwell collector and expert, was abruptly confronted with the insidious title risks plaguing the art market when, in March 2007, years after he purchased in good faith Norman Rockwell's *Russian Schoolroom*, the FBI came knocking on his door to reclaim the painting, which had been stolen thirty-five years earlier.

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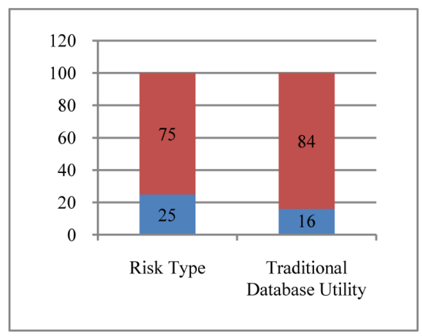
As a result of art market dynamics art buyers – whether sophisticated individual private collectors, museums or art investment funds – cannot gain critical details about a seller's legal title to the art being purchased or about the quality of the legal title in the hands of prior owners. In most cases, buyers do not even know the seller's name. Key information includes knowing whether a dealer owns the art offered for sale or is acting as an agent for the actual owner (creating issues of authority to sell and the ability to transfer good and clear title). The frequent involvement of intermediate dealers re-consigning works further removes the actual owner from the current transaction. In addition, there is no single repository of public or private records in the art industry to enable a buyer comprehensively to investigate the legal title to art, although there is varying anecdotal, sometimes publicly available and often incorrect provenance information (the record of ownership of a work of art or its whereabouts from leaving an artist's studio to the present day).

If today's art funds and other institutions cannot know the ownership risks of the art that they buy (any more than individual buyers can know this risk), then where does this leave today's investors in art funds?

Seventy-five percent of all global art market transactions are private sales by dealers and galleries, who rarely own the inventory they sell. Absent shifting the title risk to a third-party insurer (discussed below), an art investment fund's (and in turn each investor's) risk of bearing the cost of defective title turns entirely on the fund's ability to negotiate indemnification from the seller. However, even this strategy presents significant challenges because, when a title problem arises as occurred with Steven Spielberg, the fund must be able to locate, serve, sue, obtain and enforce a judgment against the seller at some unknown future date to recover the funds used to purchase this art. The seller may be an individual who is no longer alive or a dealer who is located in another country or no longer in business.

ART TITLE CLAIMS OCCUR FOR MANY REASONS



Theft (such as WWII Nazi-Era claims, illegal export/import and contemporary theft) comprises **25%** of the risk whereas Traditional Liens and Encumbrances (such as lack of authority to sell, divorces, estate issues, corporate authority and fractional ownership) make up **75%** of the risk.

Nearly one-third of art thefts are not reported to law enforcement authorities; three-quarters of art title claims arise for reasons beyond theft or "provenance." Traditional stolen art databases have a **16%** or very limited efficacy for full art title risk management.

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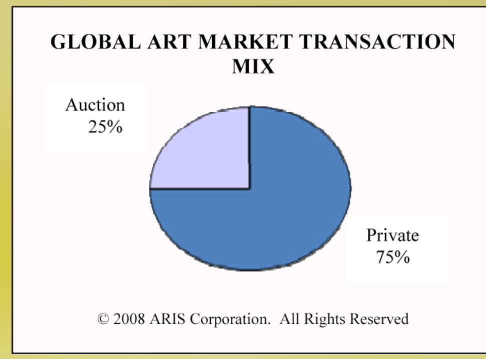
The other twenty-five percent of all global art market transactions occur through intermediary public auction houses, where there are different but equal or greater challenges to managing the title risks. Auction sales are, by industry standard, subject to the auction house's right to rescind the sale without time or other limitation and without liability to the auction house if questions later arise about who has legal title to sold works. Any such rescission would negatively impact an art investment fund both as a buyer and as a seller of art fund assets.



Fund Strategies for Managing the Spectrum of Art Title Risks And Fully Disclosing Art Title Risks to Investors

Art funds which solicit investments from qualified investors as defined by the U.S. Securities Act of 1933 (as amended) are subject to the corollary obligations of this law (or parallel laws of other jurisdictions) to disclose fully each and every risk which might impact an investor's return on investment.

When considering investing in an art fund, potential art fund investors should ask the fund's management two basic threshold questions: what are all of the "risk factors" unique to investing in art as an asset and what is the fund's strategy for managing these risks? If a fund simply says it manages the risk of defective title by purchasing and selling art in accordance with art industry due diligence practices, then the investor should ask for further disclosure of how the fund plans to overcome three critical issues: (i) lack of transactional transparency in the art industry; (ii) lack of efficacy as a true financial guarantee to the fund of warranties of title and indemnities from sellers; and (iii) financial losses due to the unlimited warranties of title the fund must give when selling the fund's works (both privately and at auction, the latter of which is the most likely avenue for sale for market neutrality and fiduciary reasons) to meet investor returns and fund exit goals.

Potential art fund investors should also explore the fund's strategies for enhancing the value of the works that the fund purchases. The most commonly employed strategy for enhancing the value of art is to cultivate public and scholarly exposure, which is most often achieved by lending artwork to museums for exhibition. Yet, the very exposure desired to enhance the value of a work often becomes the event which gives rise to a title or ownership claim because the exhibition (or publication) of the work may be the first time in years that the work's location or current owner is publicized and becomes known to potential claimants or professional plaintiff attorneys.

How Can Funds Manage Art Title Risks in Fulfilling Their Exit Strategies?

As indicated, art investment funds will generally sell the works they own via the auction market to assure market neutrality and to help to fulfill the fund's fiduciary duties toward its investors.

Given the warranty of clear title a consigning fund must contractually give in order to sell at auction, and given the auction house's unlimited right to rescind the auction sale against both the consignor and the buyer if a title issue arises at any time after the sale, art investment funds need to set aside reserves for this unfortunate contingent liability.

Potential art fund investors should ask the fund's management how the fund plans to achieve targeted returns at the forecasted exit horizon given the need to reserve against the liability to disgorge proceeds from rescinded art sales and without creating financial liability to the fund's investors if the fund has not adequately reserved against these liabilities.

Title Insurance:
The Alternative to Fund Self-Insuring Against Art Title Risks

In theory, an art investment fund could very explicitly state that it is self-insuring and fully reserving against the art title risk. However, in order to make an adequate disclosure, a fund must disclose the nature and severity of every title risk for each work of art owned by the fund. Few funds are likely to possess the requisite knowledge to make sufficient disclosures and to set aside adequate reserves based on actuarially sound assessments. Furthermore, funds taking a self-insurance approach will face enormous challenges in providing full exits for its investors: how long must the fund reserve against the contingent title risk liability and how much money should it continue to reserve?

The only alternative to self-insuring for art investment funds (as well as other art transaction principals) is to secure title insurance for the art, which has evolved in the market as a means to manage art ownership risks. Certainty of legal ownership is the lynchpin to the ability to buy, sell, gift or otherwise deal with any kind of property efficiently including and especially art for the reasons already described. This point is just as true for art as it is for real estate, and it is just as true for art investment funds as it is for individual collectors and other art market participants. Analogous to title insurance for real property, key features of art title insurance are: (i) a one-time premium for coverage for the life of ownership of the work (and the life of ownership of the heirs at law for individuals); (ii) no deductible; (iii) full indemnity for the value of the art based on the purchase price or a fair market value appraisal of the art for owner-in-possession policies: and (iv) defense costs outside-the limits, that is, in addition to the indemnity for the insured work. Policy endorsements can provide for increases in limits for works which appreciate in value after the policy incepts.

Proactive art investment funds now frequently incorporate art title insurance into their business and investment model – buying policies as part of their ordinary business practice for each artwork acquired by the fund regardless of the specific works' art title risk profile – to protect consistently and uniformly investor funds and investment returns.

Conclusion

This article barely scratches the surface in terms of the depth and breadth of title risks in the art world. These risks apply broadly to all genres, media, periods and types of art in which art funds invest today including other personal property objects such as rare books and manuscripts, vintage automobiles and rare musical instruments. The risk of defective title is compounded when art investment funds engage in tax strategies with their art (IRC Section 1031 "like-kind" exchanges for collectibles are permissible under defined circumstances but are beyond the scope of this article).

Properly managed art funds offer new and exciting opportunities for potentially significant returns for their investors as the market continues to embrace art as a new asset class and alternative form of investment. Art fund investors can and should prudently and proactively manage their investment by understanding how their art fund or any proposed art fund plans to manage the inescapable title risks associated with buying, selling and simply owning art. [1]

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Lawrence M. Shindell, J.D., is Chairman & CEO of ARIS Corporation. ARIS is the world leader in art title insurance and serves the art market and the fiduciary banking, legal, museum and broader non-profit communities. For more information, see www.aris-corporation.com.

[1]For highly pertinent and current information about the art investment fund market, see www.fineartwealthmgt.com, based in London, UK, and the leading advisor to the art investment fund market globally.