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Generations Summer 2022 - More Than a Pretty Picture: Unlocking Value in Artwork

The dramatic sale of Andy Warhol's *Shot Sage Blue Marilyn* (1964) at Christie's on May 9 for $195 million established this painting as the most expensive 20th-century work of art to sell at auction.

Art and money have been linked for centuries. The art market has ascended to true globalization, and given the full calendar of international art fairs coupled with the rise in infrastructure and the widespread acceptance of formalized legal agreements, greater attention is being focused on the financial aspects of artwork. There is now widespread acceptance of artwork as an alternative investment asset, to the point where a substantial number of wealth managers now address art specifically.

With the heightened attention on the financial value of artwork and the greater potential to unlock the value of an illiquid asset, art loans have gone from a niche category to a central part of business for a range of institutions, from large banks such as Bank of America and Morgan Stanley to boutique lenders, including Athena Art Finance and The Fine Art Group, and also the major auction houses (e.g., Christie's and Sotheby's). Deloitte estimates in its 2021 Art and Finance Report that outstanding art loans could reach $31.3 billion, with art-secured loans to private collectors potentially exceeding $25 billion. While art loans can provide the owners of artwork with a relatively low-cost source of liquidity, those borrowers should be aware of other considerations for any artwork that becomes collateral.

Borrowers can range from individual collectors who hold their artwork directly or through entities to trusts, estates and charitable organizations. Borrowers will enter into art loans for a variety of reasons. In some instances, a borrower may seek to free up cash for additional investments in the financial markets. This may be particularly attractive in low-interest-rate environments, especially when a borrower is working with a large bank with which the borrower has an existing relationship. In other cases, collectors will seek to free up funds to acquire even more artwork. Regardless of the reason, there are now many different institutions that cater to the entire range of borrowers.

How Does an Art Loan Work?

In an art loan, the artwork serves as collateral for the loan. Loans can be either recourse or nonrecourse, meaning that the borrower's other assets may or may not be at risk in a default. Larger institutional lenders typically use nonrecourse loans, which generally allow the borrower to retain possession of the artwork. The institution will enter into a security agreement with the borrower and will file a financing statement with the appropriate U.S. jurisdiction to put other lenders on notice of its priority in the event of a default. With recourse loans, the lending institution may take possession and control of the artwork.

In the case of borrowers that are private foundations, it is essential that the board review any proposed art loan agreements for compliance with U.S. federal tax law and applicable state law governing tax-exempt organizations, particularly in connection with self-dealing transactions.

a. General Requirements

There are a number of requirements that attach to an art loan, depending on the lender's size and structure, but the following factors will generally apply to any art loan.

First, the lender will assess the value of the collateral. Each lending institution maintains different minimum valuations of the borrower's art collection before it will consider a loan. Some institutions will also take into consideration their current relationship with the client in terms of providing flexibility, particularly in the case of large banks. The institution will typically

offer loans based on a 50% loan-to-value ratio on the collection of artwork as a whole. A bank making an art loan will likely require that the borrower maintain a minimum account balance with the bank as well. Borrowers should also be aware that new appraisals will be required during the term of the loan, with the risk that an appraised valuation could trigger a need to sell the artwork or liquidate other assets quickly to prevent a default based on the terms of the loan.

Second, the institution will consider the diversity of the collection, specifically the extent and quality of the collection, in determining the lender's ability to liquidate collateral in case of a default. Generally speaking, the art market disfavors large sales of work by one artist at one time, due to the risk of flooding the market. Therefore, excessive holdings by a single artist may prove difficult to liquidate, and a range of artworks provides better collateral. For boutique lenders, these requirements may be looser, although higher interest rates will likely apply.

Finally, the institution may consider the location of the artwork. Some institutions will only lend against works located in the United States, while others can lend against works in other countries.

It is important for any borrower considering an art loan to know that documentation of his or her ownership will be required (i.e., invoices, bills of sale and other evidence of ownership that demonstrates clear title). Borrowers should keep this information handy; ideally these documents are included as part of a larger collection management process. Given recent high-profile cases highlighting the dangers of opacity of ownership in certain art transactions, together with expanding sanctions in connection with Russia, lending institutions are paying even greater attention to due diligence concerning proof of ownership of artwork.

b. Ongoing Considerations During the Course of the Loan

Even though the borrower may retain possession of the artwork, restrictions will apply as to what the borrower may do with that artwork. In the case of tangible artwork, such as a painting, sculpture or photograph, the institution will note the location of the artwork. In the due diligence process, the institution may approve of multiple locations that the collector may use to house the artwork, and the artwork may be stored in any of these locations with only prior notice.

A borrower should be aware that any change in ownership structure, such as moving artworks into a limited liability company or other legal entity, or in location, such as movement to a new residence, will require prior notification and potentially an amendment to the agreements governing the art loan and new legal filings to protect the lender's security interest.

Borrowers, especially collectors who are active in the marketplace, should be aware that pledged artwork cannot be placed for sale without prior consultation with the lender. In some cases, this can be addressed by substituting artwork of equal or greater value.

A borrower will need to maintain adequate insurance throughout the course of the loan, with the institution imposing certain requirements for coverage. The institution will also need to be named as an additional insured.

Estate Planning Considerations

Borrowers should also take note of any artwork that is pledged when thinking about the impact on their estate planning. For example, if artwork is functioning as collateral at the time of the owner's death, additional restrictions may apply before that artwork may be distributed from the estate. For artwork that is owned through a business entity, the valuation of the entity may be impacted by the valuation of the artwork. In the case of a boutique lender, the lender may have possession of the artwork in its storage facilities. For artwork that is subject to a pledge agreement with a charitable institution, borrowers need to ensure that the pledge agreement is consistent with the terms of the documents governing their art loan.

Conclusion

Art loans are a viable option for unlocking the value of an otherwise illiquid asset. When contemplating an art loan, owners of artwork should be prepared to work with an art advisor or otherwise consider their plans for artwork prior to entering into any formal agreement with a lender in order to make sure they understand the details of the arrangement and that their rights are adequately protected.

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