"Co-Investing in Art: What Every Art Fund Manager Needs to Know"

By Enrique Liberman and Javier Lumbreras

Art investment funds have long embraced the use of co-investments in artworks as a principal investment strategy. Whether such investments are undertaken with an art fund's own investors, competing art funds or other art market participants, art co-ownership arrangements offer an art fund the means to further diversify its art investment portfolio while at the same time sharing the high carrying costs of art ownership with its co-investors.

While the benefits of art co-investments clearly merit their use by art funds, art co-ownership arrangements do involve significant risks to the implementation of a fund's investment program that if not properly addressed can frustrate the fund manager's intentions regarding the ownership of, and anticipated benefits from, the co-owned artwork. As a result, art fund managers seeking to enter into art co-ownership arrangements should take the time to carefully formalize the mechanics of the co-ownership relationship with its co-investors prior to acquiring the subject artwork.

How Are Art Co-Ownership Arrangements Created?

As a general rule, art co-ownerships are created through the agreement (oral or written) of the co-owners or through the creation of a jointly owned special purpose vehicle ("SPV") that is formed to acquire one or more artworks.

If one elects to form an SPV, the parties choose a form of legal entity (typically a limited liability company or a limited partnership) and draft the governing documents for the SPV to define the nature of the co-ownership arrangement. Annual expenses relating to the ownership, management, storage and transportation of the artwork are contributed by the owners of the SPV pro rata based upon the ownership interests in the artwork.

The use of an SPV carries with it a number of advantages and disadvantages. By contributing the co-owned artwork into the SPV, the owners are able to insulate the picture from claims of the creditors of one of the owners. Moreover, the formation of an art investment vehicle provides greater support for the deduction of the costs and expenses of acquiring, managing and disposing of the artwork. On the other hand, an SPV involves incurring substantial expenses in the formation and governance of the legal entity that a purely contractual co-ownership agreement avoids.

Important Mechanics of the Co-Ownership Relationship.

In crafting a co-ownership arrangement, art fund managers should address, and with their fellow co-investors agree upon, the following decisions relating to the subject artwork:

Ownership Interests. The particular ownership interests of the respective co-owners in and to the jointly owned artworks should be clearly delineated either through an express understanding in the co-ownership agreement or by way of the underlying equity interests of each party in the SPV owning the subject artwork.

As a general rule, art fund managers usually insist upon owning a majority of the ownership interests in and to the underlying artwork, although a minority equity position in the work can sometimes occur to the extent that the co-ownership arrangement affords the art fund manager with management responsibilities over the subject artwork commensurate with a majority ownership position.

To the extent that the parties intend to allocate profit interests and/or responsibilities for paying the costs of owning the artwork other than based upon their pro rata payment of the purchase price, such understandings should be expressly addressed in the co-ownership agreement or the governing documents of the SPV, as the case may be.

In particular, the parties should reflect upon and reach agreement as to whose responsibility it is to fund storage costs, insurance premiums, transportation expenses, cataloguing fees, litigation costs to defend the work against competing title claims or attribution problems, conservation costs, and legal fees relating to purchase/sale agreements, consignment agreements, and loan agreements.

Moreover, the parties should discuss consequences of any party failing to meet their ownership obligations. Art fund managers should at a minimum insist upon having the right (but not the obligation) to fund ownership expenses on behalf of any defaulting co-investor at a predefined interest rate with such advanced sums and accrued interest being taken first from the proceeds of any sale of the co-owned artwork. In doing so, a fund manager can ensure that all requisite actions are taken with respect to the artwork to minimize the risks associated with an investment in the same.

Management. Of primary importance in a co-ownership structure is the manner in which the artwork will be managed. While it may seem that the co-owners have a comity of interest in owning the artwork(s), the reality is that each owner has his own specific needs and objectives that in many cases may contradict those of their fellow co-owners.

In particular, art fund managers have specific investment objectives relating to its acquired artworks that are often at odds with those of its fellow co-investors. Moreover, as the fiduciary for its investors, an art fund manager must employ additional safeguards in connection with its acquisition, management and disposition of its artworks than those generally utilized by its co-owners.

Henri Rousseau. *The Dream.* 1910. Oil on canvas.

As a result, art fund managers should address with their co-investors how the following decisions will be made between them:

- Possession. The question of who has the right to possess the artwork is particularly important to an art fund manager. Will the artwork be stored in an independent warehouse and accessible only with the consent of the art fund manager or will one or more of the owners have rights to display the work in their respective homes?

  An art fund manager should insist upon maintaining rights to possession of the subject artwork at all times. In doing so, the manager can alleviate the risks of having a co-owner sell the work without the fund's permission or having a co-investor's creditors seek to seize the work in satisfaction of outstanding indebtedness.

- Museum Loans. A primary investment strategy of most art funds involves the showcasing of the fund's artworks pursuant to a robust exhibition program in order to increase the artwork's marquee value. However, when an artwork is co-owned with other parties, one must ask: Who decides when, where and for how long a co-owned artwork will be exhibited at a museum or fine art gallery? Who will negotiate and signoff on the terms of such a museum/gallery loan? Will anyone be named in the exhibition catalogue as the owners of the work or is anonymity preferred?

  Art fund managers must insist that museum loan agreements require that only the fund manager has the right to give instructions or consents regarding the loaned art work, including in connection with requests by the borrowing institution to repair, clean, fumigate or frame/re-frame the work. Moreover, the identity of all of the co-owners must remain anonymous in connection with an exhibition of the artwork in order to prevent the artwork's sale prospects from being diminished in the future due to its association with an art fund or an identified art collector or dealer.

- Leveraging. Can the co-owned artwork be used as collateral for a loan? Who negotiates the provisions of the loan agreement? Must all owners agree to leverage a work or can the majority owners make the decision? Will the parties escrow a portion of the loan proceeds to cover interest payments? If not, what happens if one of the co-owners fails to pay his pro rata portion of the interest?

  In answering these questions, an art fund manager must be sure that it can maintain compliance with any restrictions or prohibitions on leveraging artworks set forth in the governing documents of its art fund or in the loan documents of the art fund's underlying credit facilities.

- Disposition. Who determines how, when and on what terms are artworks to be sold? Is it better to sell a work via a private sale or at a public auction? What is the sale price for the work or minimum reserve price in the event of a consignment to an auction house? Who determines which art dealer or gallery will sell the co-owned artworks?

  Unlike individual collectors, art funds have specific holding periods for artworks in their portfolios that cannot be subject to any differing investment horizons of the other co-owners. Accordingly, an art fund manager should be the ultimate decision maker as to when a co-owned artwork is to be sold. To the extent that the other co-owners wish to participate in the decision as to when to sell the subject work, there should at a minimum be an outside date upon which their consent is deemed to be given to any desired sale by the art fund manager, such date typically coinciding with the end of the defined life of the art fund.

  Likewise, an art fund manager should insist upon controlling the actual sale process for the co-owned artwork in order to not only maximize the sale proceeds for the art fund's investors but also to avoid, or at a minimum disclose and clear with the fund's investors, any possible conflicts of interest inherent to the proposed avenue of sale for the work.

  The purchase and sale documentation and any consignment agreements should be negotiated by the art fund manager. Among other things, they should provide that the other co-owners are liable for (i) their pro rata portion of an indemnification obligations owed to the purchaser of the artwork and (ii) the return of their portion of the sales proceeds from the sale of the artwork in the event the sale is rescinded in the future.

- Interventions. Who determines the need for and character of any interventions on the co-owned artworks such as repairs, restorative work, cleaning, fumigation and/or framing/reframing? What conservator, framer or other outside service provider will be engaged to perform such intervention and on what terms and for what price?

- Storage and Insurance. Who decides where, how and with whom the co-owned artwork is stored? What insurance carrier will provide both "all risks" insurance and art title insurance? At what value should the work be insured for? At what intervals should the work be revalued for insurance purposes? Who shall bear the costs of insuring and storing the work?

Art fund managers must be sure that they comply with the various operational protocols communicated to their investors in their fund's underlying offering documents. For example, many art funds commit to their investors that they will undertake annual appraisals of the artworks in the fund's portfolio and adjust the insurance coverage to account for any increases in value. Likewise, any artworks co-owned by the art fund must also adhere to such procedure.

Moreover, many art funds will suffer adverse tax consequences and incur additional customs duties and other charges depending upon where the artworks are stored or sold from. Accordingly, there should be agreement amongst the co-owners as to where the artworks will be stored.

Voluntary and Involuntary Transfers.

During the term of the co-ownership arrangements, foreseeable and unforeseeable events can occur that threaten the constancy of ownership of the underlying artwork. Accordingly, the parties to a co-ownership relationship should address the rights and restrictions on transferring their interests in and to the subject artwork or SPV, as the case may be, in various circumstances.

Voluntary Transfers. As with any relationship, there exists within the co-ownership context the possibility that one of the parties may wish to end his involvement with the subject artwork and the other co-owners. There may have been a falling out between the co-owners, a change in the level of risk one owner is willing to accept or a discrepancy between the owners as to the benefits they wish to derive from the investment in the artwork. Regardless of the motivation, it is not unreasonable for one of the co-owners to wish to sell his ownership interest in the artwork or the SPV, as applicable.

That being said, such potential transfers bring with them the aforesaid potential changes of control or the inclusion of an unknown or unwanted partner, especially when the selling party holds the majority interest in the artwork or SPV. As previously discussed, art fund managers should always seek to maintain management control over the artwork or SPV. Accordingly, the central concern for art fund managers resides in the prospect of the participation of new and unwanted partners, especially those likely to impact the management and ultimate realization of the subject artwork.

Aelbert Cuyp. *An Equestrian Portrait.* Oil on cradled panel (30 x 42 in.)

To address the adverse consequences of a voluntary transfer of an interest in the co-owned artwork or the SPV owning the same, the owners can and should utilize various techniques.

The most commonly used restriction on voluntary transfers is the granting to the remaining co-owner(s) of a right of first refusal. Such right requires the selling party to notify the remaining owner(s) of an unrelated bona fide third party offer for the selling party's ownership interest in the artwork or the SPV, as the case may be. Such remaining owner(s) are then afforded the opportunity to match the third party offer.

The use of a tag-along right is also available to protect the interests of the co-owners in the event of a desired transfer by one of the owners and often arises in the context of an unexercised right of first refusal. A tag-along right grants the non-selling co-owner(s) the right to have their interests in the artwork or SPV included pro rata in accordance with their ownership interests in any potential sale of interests by a selling owner. When combined with a right of first refusal, the

remaining owner(s) are in essence granted two options, the right to acquire the selling owner's interests or the right to reduce their own interests. Tag-along rights are particularly helpful in cases where the remaining owner(s) wish to mitigate the potential risk of the art co-ownership by availing themselves of a selling opportunity. However, the use of a tag-along right in a co-ownership arrangement can complicate the efforts of a selling owner to dispose of the entirety of his or her interests in the artwork or SPV as the potential sale would be subject to such rights.

Auguste Renoir. *La Promenade*. 1870. Oil on canvas.

As previously discussed, art fund managers must retain control over the decision of when to sell the artwork or SPV. It is therefore advisable for the co-owners to at the onset of the co-ownership arrangement agree to a drag-along right, which provides the art fund manager with the power to negotiate the sale of all of the ownership interest in and to the artwork. In such circumstances, the other co-owners must sell their interests to the prospective purchaser on the same terms pro rata as the art fund. This is particularly important as the drag-along right ensures that minority interests do not succeed in frustrating the legitimate efforts of the art fund to realize the gains achieved from the investment in, and ownership of, the artwork.

Involuntary Transfers. Even when the relationship of the co-owners is intact and the parties maintain the same vision as to the direction of the art investment, certain events can and do arise that in essence will end an owner's ownership of a portion of the artwork or SPV, as the case may be. The primary examples of such events lie in cases of the death, bankruptcy or divorce of a co-owner. In such instances, it is important to provide protections to the remaining co-owner(s) so as to ensure the constancy of ownership over the subject artwork or SPV as well as provide ample liquidity for the interests of the departing owner.

Upon the death of one of the co-owners, it is important to provide for an immediate required purchase by the remaining co-owner(s) of the decedent's interests. While the owners can instead opt for a call right by the remaining co-owner(s), the practical effect of such option is to deny the estate of the decedent with a guaranteed outlet for the disposition of its interests, forcing it to seek out third party purchasers which often results in the artwork being "burnt" and unable to be sold by the remaining co-owners in the near future. The use of a mandatory buyout in cases of the death of a shareholder is also useful in preventing the unwanted and potentially detrimental participation of relatives of the deceased who in many cases will have differing views regarding the co-ownership arrangement.

The bankruptcy and/or insolvency of an owner can also lead to the unwanted inclusion of his or her creditors as co-owners of the artwork or SPV. Such creditors can and often do have different objectives for the direction of co-investment, most notably the recapture of monies owed to them by the bankrupt owner. Accordingly, the remaining co-owner(s) should be given the right, but not the obligation, to purchase the shares of the bankrupt owner.

Just as in the case of the death of an owner, the termination of a marriage of an owner can have

similar consequences upon the ownership of the co-owned artwork or SPV. In many jurisdictions, the ownership interests in and to the artwork or SPV are deemed to be marital assets and can be divided or fully transferred to a non-participating spouse as part of a divorce settlement, thereby resulting in the participation of an unwanted (and possibly angry, bitter and difficult) partner in the co-ownership arrangement. To answer this problem, the co-ownership agreement or the governing documents of the SPV should grant the remaining co-owner(s) the right, but not the obligation, to purchase the interests of the divorcing co-owner upon the occurrence of a divorce or other marriage dissolution event.

The parties should also consider that the actions of a particular co-owner could merit or require the buyout of his or her interests by the remaining co-owners. For instance, the failure of a co-owner to maintain the confidentiality of the co-ownership arrangement or to make his required contributions to the management of the co-owned artwork or SPV can lead to adverse consequences to the co-ownership relationship. As a result, a breaching owner can be required to sell his or her interests to the other co-owners at the election of the other co-owners.

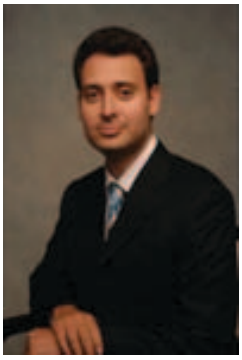
Of critical importance to buyouts resulting from involuntary transfers is the methodology to be used by the co-owners to value the departing owner's interests in the artwork or SPV. In general, values vary depending upon one's assumptions and purposes behind a particular valuation. For example, different values are often obtained for the same artwork depending upon whether the valuation is for insurance or sale purposes. As a result, the owners should agree at the onset of the co-ownership relationship upon the means by which the interests in the artwork or SPV to be purchased are to be valued.

The most common approach lies in the use of an appraiser to value the artwork as of the date in which the event triggering the involuntary transfer occurred (e.g., the date of death of one of the owners). The co-owners must determine the procedures upon which an appraiser is identified and engaged as well as the manner in which such appraiser is to conduct the valuation. Primary issues of concern reside upon ensuring the independence of the selected appraiser and deciding upon any discounts to be applied to minority ownership interests or the interests of co-owners that have materially failed in their obligations to the co-ownership arrangement.

As art funds rarely if ever suffer the kinds of events that yield involuntary transfers, art fund managers naturally should seek to employ methodologies that result in lower valuations for interests in the artwork or SPV, as applicable.

Conclusion

Art funds have and will continue to utilize co-investments as one of their primary investment strategies. In pursuing such co-investments, an art fund manager must remember both its fiduciary obligations to its investors as well as the terms of its fund's governing documentation when crafting such a relationship. By focusing the attention of the other co-owners on the mechanics of the co-ownership arrangement, an art fund manager can help the participants agree on the particular attributes of their relationship and in doing so, prevent both foreseeable and unforeseeable events from hampering their intentions regarding the ownership of, and anticipated benefits, from the co-owned artwork.



Enrique Liberman *is the President and member of the Board of Directors of The Art Fund Association and a Partner in the Art Law and Art Funds and Corporate & Securities practice groups of the law firm of Di Santo Bowles & Bruno LLP in New York City. Mr. Liberman is also the Chair of both the Best Practices Committee and the Art Due Diligence Committee of The Art Fund Association, playing a central role in the development of best practices for the fine art market. Mr. Liberman is a prominent art law attorney who counsels art investment funds on their formation and governance and regularly writes and speaks on issues affecting the art fund industry. Mr. Liberman is also the Chair of the New York State Bar Association's Committee on Art Law, Art Funds and Art Investment. Mr. Liberman is a graduate of Harvard Law School ('99) and Stanford University ('96).*

Javier Lumbreras *is the Chair of the Board of Directors of The Art Fund Association and the founder and Chief Executive Officer of the Artemundi Global Fund, a diversified art investment fund with a strategic art investment portfolio covering half a millennium of universally recognized artists. Mr. Lumbreras serves on both the Best Practices Committee and the Art Due Diligence Committee of The Art Fund Association, and in doing so has been instrumental in fostering best practices for the art fund industry. Mr. Lumbreras is a respected consultant to private collectors, a sought after guest lecturer regarding the art market to banks, family offices and museums and a trustee to various international art institutions. He is also the author of the book, The Art of Collecting Art.*