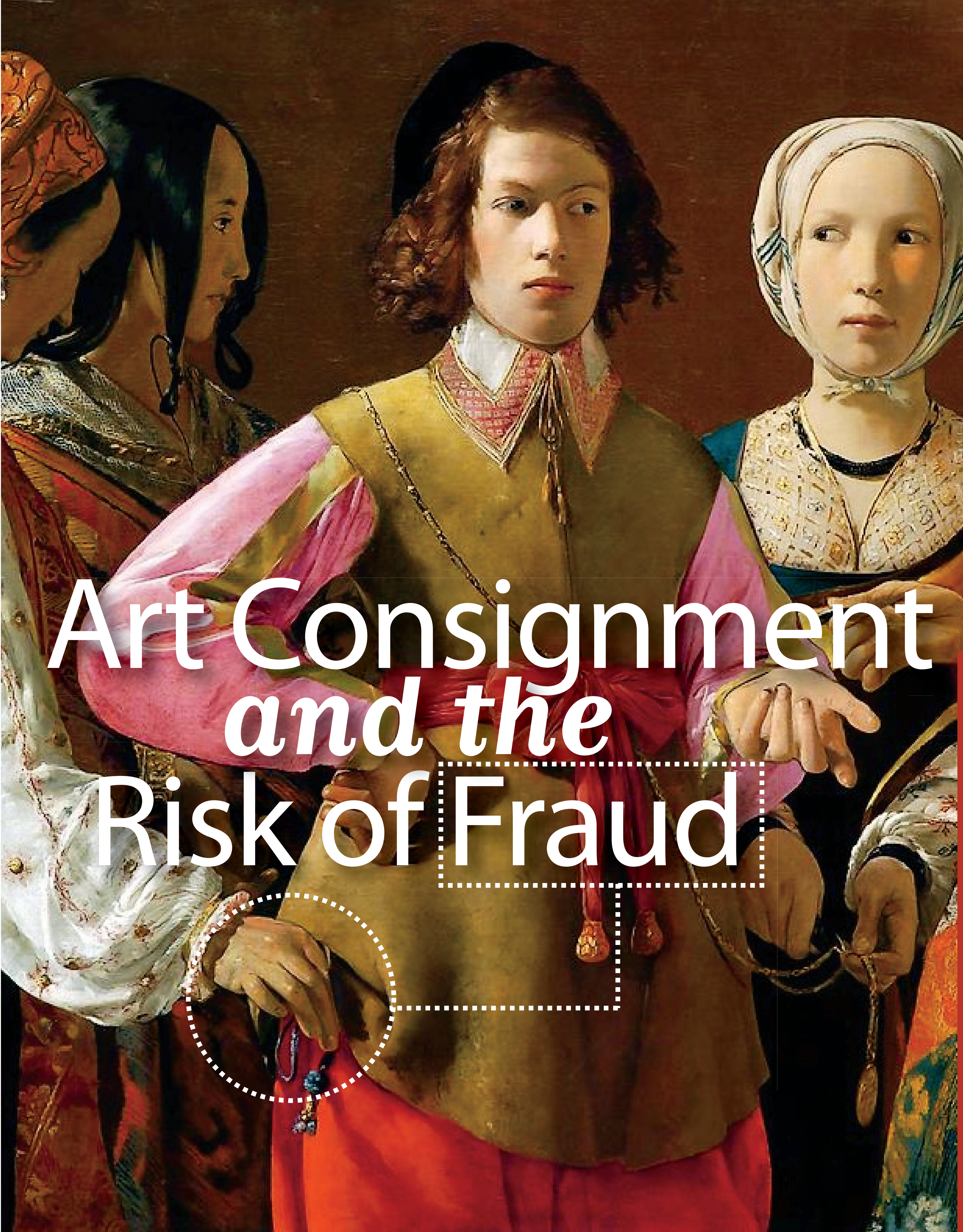

Art Consignment *and the* Risk of Fraud

BY KEVIN P. RAY

Many art transactions involve the owner or seller of a work consigning the artwork to another for sale. While art consignment fraud can involve a dealer failing to pay the owner the proceeds from a sale, it can also arise from many other forms of fraudulent behavior – double-pledging, selling, or transferring without authorization, even engaging in undisclosed sales commission arrangements.

As headlines trumpet ever-higher auction prices, wealth managers analyze art as an investment asset class, and secured lenders consider ever more deals in which their collateral includes art, public and business attention focuses intently on the art world. Since many art transactions depend on the owner or seller of a work entrusting the artwork to another for sale, it is important to understand not only the nature of these transactions, but also the risks attendant upon them. While art consignment fraud can involve a dealer failing to pay the owner the proceeds from a sale, it can also arise from many other forms of fraudulent behavior: double-pledging, selling or transferring without authorization, even engaging in undisclosed sales commission arrangements.

The most common art-entrustment arrangement is a "consignment," which the Uniform Commercial Code ("UCC") describes as a transaction "in which a person delivers goods to a merchant for the purpose of sale." UCC § 9-102(a)(20). The UCC provides important protections for the owner (the "consignor"), including giving the consignor a purchase money security interest in the consigned artwork, which gives the consignor a superpriority right to the artwork and its sales proceeds, superior to the rights of other creditors. UCC § 9-103(d). However, the consignor must perfect its consignment interest by (i) filing a UCC-1 financing statement describing the artwork before delivering the artwork to the consignee, and (ii) sending a notice to the consignee's secured creditors describing the artwork and stating the consignor's intention to retain a consignment interest. UCC § 9-324(b). A consignor's failure to perfect its consignment interest can render the security interest subordinate to the interests of the consignee's bankruptcy trustee, secured creditors, and judgment creditors.

Consignment Fraud and Perfection Risk

Recent years have seen the collapse of several major art galleries, some from financial conflicts with lenders or other parties, other from shady business practices and outright fraud. Perhaps the most spectacular was the collapse of Salander O'Reilly Galleries, LLC ("SOG"). In 2007, facing numerous lawsuits alleging that SOG had sold works, double-pledged works, and failed to pay consignors proceeds from sales, SOG filed for relief under Chapter 11 of the Bankruptcy Code. One of the most dramatic near-losses suffered in the SOG case arose when Kraken Investments, Ltd. ("Kraken") consigned Sandro Botticelli's *Madonna and Child* (1485) to SOG, but then failed to file a UCC-1 financing statement to perfect its consignment interest.[1] This failure opened the door to the very real possibility that in SOG's bankruptcy case, either the bankruptcy trustee or SOG's working capital lender (who had a blanket security interest in SOG's assets) would have priority over Kraken's interest in the painting.

The bankruptcy court rejected Kraken's claim to priority in the painting, and the district court affirmed that decision, stating that:

> The Court well understands why Kraken is perturbed, even outraged, by the idea that SOG's creditors may enjoy proceeds from the sale of a valuable painting concededly owned by Kraken. The law of the state in which Kraken consigned the painting, however, allows for such an outcome where the consignor does not protect itself by filing a financing statement giving notice of the consignment to the consignee's creditors. Whether that result will obtain here remains to be seen. But while Kraken may have thought it was protecting itself vis-à-vis SOG by the arbitration and choice-of-law clauses in the Consignment Agreement, it did not protect itself via those clauses when it came to SOG's creditors.[2]

Ultimately, more than seven years after the SOG bankruptcy case began, and nearly eight and a half years after Kraken consigned the Botticelli to SOG, both Kraken and the bankruptcy trustee filed motions for summary judgment, and the outcome turned on whether the language of SOG's security agreement with its lender included consigned works such as the Botticelli painting (the bankruptcy trustee relied solely on his position as assignee

of the secured lender's claim, and not on his inherent power under the bankruptcy code to avoid unperfected liens). The bankruptcy court held that it did, but the district court disagreed. In awarding the painting to Kraken, the court held that:

> [t]he Court disagrees with the Bankruptcy Court's interpretation of the Loan Agreement. Although the Court agrees the Loan Agreement can mean only one thing, what it plainly means is that the Bank was given a broad security interest in inventory *owned* by the Debtor. As such, the Loan Agreement unambiguously does not grant the Bank a lien on consigned artwork.[3]

In the end, what for a time appeared to be one of the most dramatic and best-publicized losses suffered in the SOG case turned on a question of contract interpretation.

Unauthorized Resale and Misrepresented Replacement

While the *Kraken* case involved a nearly-catastrophic loss to a consignor when its fraudulent consignee suffers financial collapse, in *Seung v. Fortune Cookie Projects*[4] the buyer of a painting suffered losses from a seller's double-dealing. In *Seung*, the purchaser bought and paid for a painting. However, before the buyer could take possession of the painting, the dealer resold it to another buyer at a profit, even though the buyer had not authorized the resale. The dealer did not refund the purchase price of $118,000, but instead offered the buyer a $200,000 credit toward the purchase of another painting (which amount included an $82,000 profit on the sale of the original painting). The dealer offered the buyer a replacement painting, which the dealer represented as being worth $500,000, although she would sell it to the buyer for $380,000 (the $200,000 credit plus an additional $180,000). After the buyer agreed to purchase the replacement painting, the buyer discovered that the painting had recently sold at auction for $156,000 and had been appraised at a value of only $100,000-110,000.

The buyer brought suit against the dealer, alleging fraud, negligent misrepresentation, and unjust enrichment. Both the trial court and the appellate court, however, rejected the buyer's claims, finding that the purchase of the second painting was an arms-length transaction. The court held that no special relationship existed between buyer and seller, and the buyer was not entitled to relay on the dealer's representations. Rather, the court noted, the buyer could have obtained her own appraisal of the painting, but chose not to do so.

Undisclosed Sales Commission

Art transactions sometimes involve multiple levels between the ultimate seller and the ultimate buyer, as well as a preference for anonymity for some parties. This can result in a lack of transparency even to the financial terms of the transaction. This was precisely the problem in *Accidia v. Dickinson*,[5] a British case in which a seller consigned a drawing attributed to Leonardo da Vinci to a London dealer. The dealer to whom the seller consigned the drawing, in turn, entered into an agreement with an intermediary dealer, who then sold the drawing to the ultimate buyer. The seller was told that the purchase price was US$6,000,000. Of that, the seller would receive US$5,500,000, with the remaining US$500,000 to cover expenses and a commission of ca. 10%.

However, under a "net return price" arrangement, the intermediary dealer actually sold the drawing to the ultimate buyer for US$7,000,000, pocketing the excess above the US$6,000,000 purchase price that had been quoted to the seller. When the buyer later raised concerns about the authenticity of the drawing and sought rescission of the sale, at which point the original dealer discovered the actual purchase price, and litigation ensued. The High Court of Justice found for the seller, holding that the intermediary dealer was acting as an agent for the seller, and so owed the seller a fiduciary duty. The court held that a "net return price arrangement would only have been acceptable usual practice if [the original dealer and the seller] were being told the ultimate price." Consequently, the court ordered the intermediary dealer to disgorge certain of its excess commission.

What is a Consignor (or Buyer) to Do?

Art consignors (and buyers) should not be lulled into complacency by the informal, relationship-based norms of art transactions. They need to be aware of (and comply with) the rules that are in place to protect them, just as they would in any other type of business transaction.

1. Consignors should:
   a. Research the consignee (reputation, professional organization memberships, litigation).
   b. Require that all consignment agreements be in writing.
   c. File UCC-1 financing statements for consigned works.
   d. Periodically monitor the status of the consignment (including reviewing the consignee's exhibitions and catalogs, visiting the consignee to confirm condition of the work, obtain regular status updates from the consignee).
   e. Confirm sale price and commission.

2. Buyers should:
   a. If buying, research the work itself (sales/auction records, provenance records, lost art databases).
   b. Obtain an appraisal. **TSL**

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1. *Kraken Investments Ltd. v. Jacobs (In re Salander O'Reilly Galleries, LLC),* 475 B.R. 9 (S.D.N.Y. 2012).
2. *Id.* at 32.
3. *Kraken Investments Ltd. v. Jacobs (In re Salander O'Reilly, LLC),* Case No. 14-cv-3544 (S.D.N.Y. Nov. 25, 2014).
4. *Seung v. Fortune Cookie Projects*, 28 Misc.3d 1226 (N.Y. App. Div. 2010).
5. *Accidia Foundation v. Simon Dickinson Ltd.,* Case No. [2010] EWHC 3058 (Ch), 2010 WL 4777518 (2010).