

COLLECT AND PROTECT

Sandrine Giroud, Nigel Glenday and Deborah Lechtman consider the opportunities and legal considerations of asset-based lending against art

➤ KEY POINTS

WHAT IS THE ISSUE?

Asset-based lending against an art collection can provide added flexibility for an estate-planning strategy. However, important practical and legal steps should be considered in advance.

WHAT DOES IT MEAN FOR ME?

An opportunity to advise art-collecting clients on new and valuable estate-planning strategies.

WHAT CAN I TAKE AWAY?

Understanding how art-based financing can assist an estate-planning strategy, and a checklist of practical and legal aspects to consider to help avoid pitfalls.

Building an art collection is a lifelong, often multigenerational endeavour that can account for a meaningful portion of an

estate. Among the many estate-planning hurdles that art presents is that, historically, the only practical means to monetise art has been to sell it, which can be detrimental from a tax and value-maximising standpoint. Increasingly, collectors, their families and advisors are exploring asset-based lending against art as a valuable estate-planning tool. Weak auction sales (based on the most recently available data, results at the two major auction houses are down over 30 per cent year-to-date over the comparable period last year) are generating interest in financing as an alternative channel to monetise a collection. Asset-based lending allows collectors or their descendants to access credit secured solely by the value of their art without encumbering other estate assets. This is of particular value to estates concentrated in art with financial assets required for other uses. However, in exploring art financing, several legal points must be addressed.

NEW TOOL FOR ESTATE PLANNING

Art can be a highly capital-intensive asset for which few dedicated sources of financing are available. Since the financial crisis, traditional banks have largely retrenched from asset-based lending, and certainly so against art. The few banks that do offer art lending typically also secure a collector's financial assets, resulting in far less flexibility for the collector and their estate. However, options for asset-based financing against art are growing and offer flexibility from multiple perspectives, such as:

- allowing collectors to fund cash gifts or pay the tax liability associated with taxable gifts of art to their descendants or other beneficiaries;

- providing for lifestyle expenses for collectors in lieu of a sale before death, which could otherwise trigger punitive tax consequences (e.g. a reverse mortgage for art);
- helping descendants fund inheritance taxes;
- meeting a descendant's liquidity needs without encumbering or draining an inherited trust; and
- enabling trustees and fiduciaries to cover trust expenses or distributions.

In some cases, preserving the integrity of a collection is paramount to maximising value in an eventual sale, particularly for major collections. Yet if periodic cash distributions are required by a specific estate-planning strategy, asset-based financing can be a solution to ensure that a collection remains intact for future sale, while satisfying shorter-term liabilities.

UNDERSTANDING THE REQUIREMENTS

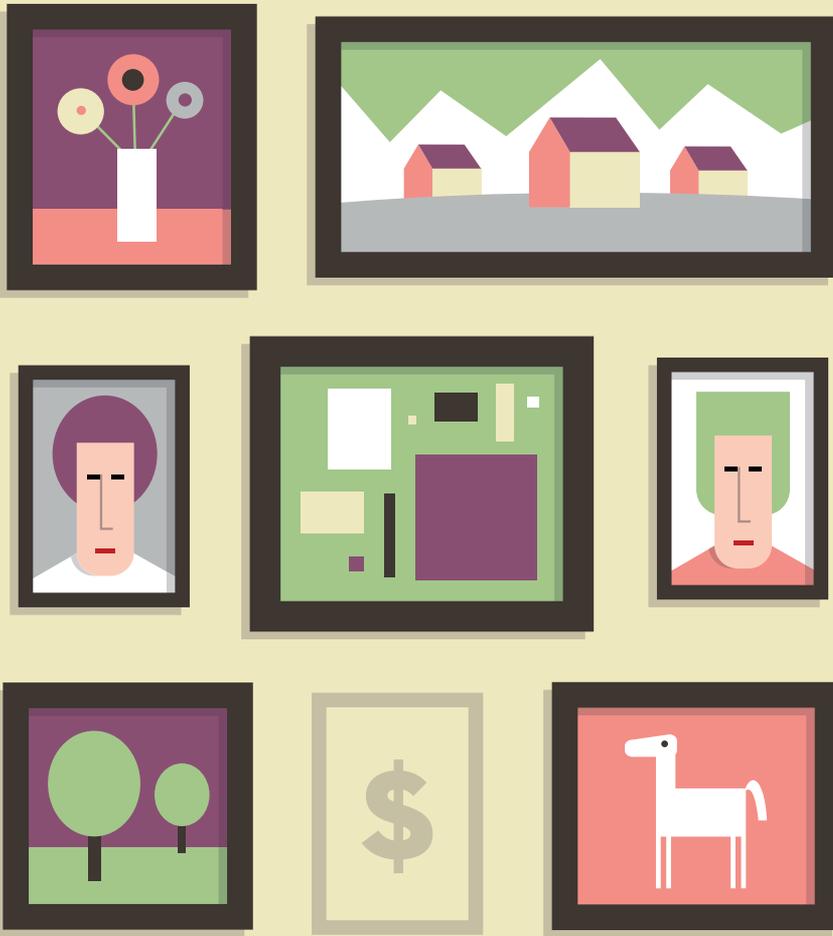
Many collectors and advisors remain unfamiliar with the basic requirements for an art-based loan. Works by artists with international demand and an established auction history most readily serve as collateral. Valuations are generally conservative estimates that would generate broad demand at auction. Loan-to-values typically range up to 50 per cent, based on a diversified collection. Transfer of possession rules vary by jurisdiction, with some requiring the lender to retain possession, and others allowing clients to keep their art, with the lender registering their collateral security interest. However, the use of specialised fine-art storage facilities or freeports is increasingly commonplace.

LEGAL CONSIDERATIONS

DUE DILIGENCE ON THE COLLECTION

Underwriting for an art-based loan begins with the initial due diligence undertaken by a collector, and adherence to best practices when managing a collection over time. The overall increase in the value of art over the past decade is necessitating greater due diligence by collectors acquiring new art. Clarifying a number of legal considerations in a purchase agreement, such as title, authenticity, exportation and applicable law, greatly help to ensure that an art collection may eventually be considered for a loan. Underwriting typically involves the review of the extent to which an art collector has addressed the following issues:

- **Provenance:** verifying chain of title helps minimise the potential for a future claim by a rightful owner or heirs in the case of artwork that may have been stolen or looted. Collectors should be in possession of documents evidencing title, such as past bills of



sale or inheritance documentation. A number of public databases are available to assist in research.

- **Cultural goods:** collectors must ensure that artwork defined as a cultural good was not previously exported in breach of cultural-goods protection laws. Similarly, collectors should ensure that their art is exportable under the laws of its current location. Several countries have strict export limitations for cultural-heritage assets and require approval for export, which is typically a requirement for an art-based loan.
- **Expert analysis:** collectors should have experts evaluate the artwork for potential issues related to authenticity and physical condition. This includes reviews of the respective *catalogue raisonné* (a list of all known artworks by an artist), exhibition history, literature, authenticity certificates (where applicable) and condition.
- **Intellectual property:** collectors must ensure they are free to transfer the artwork without violating the artist's intellectual-property or resale rights.
- **Insurance:** specialised fine-art insurance is critical for protection against risks related to damage and theft. The value set for insurance purposes must be carefully reviewed, as it may be relevant for tax purposes.
- **Customs and taxes:** customs duties and taxes must be carefully assessed to

avoid any liability that may reduce the liquidity for an artwork and limit its future transfer. Customs fees and taxes may be minimised depending on the applicable law of the collector's estate, the physical location of the artwork or the use of a legal vehicle, such as a company, trust or foundation.

In general, better-documented collections provide for faster underwriting and can facilitate an art-based loan in a matter of weeks. It is understandable, however, that the burden of thorough documentation may fall to descendants or their fiduciaries. This may prolong the underwriting process.

STRUCTURING THE COLLECTION

Without adequate estate planning, collections can be dismantled or have their value diminished, often in cases of dissension among heirs or divorce. Collectors should address upfront under which law their estate falls, and which legal structure is best suited for the collection.

The law applicable to the collector's estate is also applicable to their collection. This is critical, as it determines issues such

as: what constitutes the estate; who is entitled to it and the scope of this entitlement; who will meet the debts of the estate and the tax on it; and the legal remedies available. The estate-planning strategy should also address the particularities related to the chosen matrimonial regime, as this could have an impact in case of death or divorce.

The legal structure used to hold a collection is another crucial consideration for collectors. The main options are to hold it individually or through a legal vehicle, such as a company, trust or foundation. Each option comes with advantages and disadvantages that must be carefully discussed by collectors with their advisors.

FRAMING THE ART LOAN

When considering an art-based loan, collectors must also ensure that the art loan agreement addresses certain issues.

First, transactions are often cross-border in nature, with collections, borrowers and lenders in different countries potentially giving rise to complex conflict-of-law issues.

Second, applicable law and forum-selection clauses must be carefully addressed. Applicable law is critical to the underlying mechanism of acquisition and loss of an interest in movable property. For instance, the possession of an art collection may require transfer to a lender to perfect the lender's security interest (as is the case under Swiss law and most civil-law jurisdictions), or the transaction could be documented in an official register, such as a *Uniform Commercial Code* registration under US law. Generally, the validity of a security interest depends on the law of the country where the asset is located when the security is granted. The court chosen to adjudicate any dispute related to the loan agreement is also key, as this may impact the enforcement of the security pursuant to the applicable laws.

CONCLUSION

Asset-based financing for art provides a flexible tool for estate planning. However, professionals have a critical role in recommending prudent advanced planning. Estate-planning advisors should be prepared to take early action, including seeking outside art-law experts as needed, to ensure that an art collection's value is preserved for current and future generations.



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