

Art-secured lending: maximising liquidities opportunities for private art collectors

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Introduction

In a market worth \$64.1 billion in art sales in 2019,⁽¹⁾ art-secured lending, worth an estimated \$21 to \$24 billion in the same year, funded over one-third of those sales. In the United States, this funding contribution was far greater, given that the United States represents 90% of the global art-secured lending market.⁽²⁾

With COVID-19, investors who are facing cash calls and liquidity squeezes in other asset classes might be looking to realise some liquidity from their unsecured, unleveraged artwork collections; despite valuation risks, this could therefore be a time when investors turn to art loans to provide them with much-needed liquidity.

The concept of an art loan is relatively simple (although there is complexity behind the concept, of which borrowers must be aware): the borrower (pledgor) receives a loan from the lender (pledgee), the amount of which is determined by reference to the value of the artwork which is to be pledged. The art loan is thus an attractive concept which is increasingly seducing private clients to hold art. According to the 2019 Deloitte and ArtTactic Report, 70% of collectors – versus 57% in 2017 – indicated that they would be interested in using their art collection, or parts of it, as collateral.⁽³⁾

Part of the reason for the dominance of the United States in the international art-secured lending market is the advantageous legal environment provided by the Uniform Commercial Code.⁽⁴⁾ In Europe, the market is less developed, partly because many jurisdictions still require the physical transfer of pledged property, which effectively prevents art collectors from enjoying direct access to their collections.

Switzerland – which is home to many savvy collectors and dealers, prestigious collections, leading art fairs and longstanding freeports – is still a jurisdiction of opportunities for art lending; however, the legal framework, considered in this article, may impede its development as a non-recourse art-lending market. Nevertheless, these are exceptional times, and the current situation might prompt investors to realise short-term liquidity from their collections, with a corresponding loss of enjoyment of the pledged artwork. This article provides an overview of the Swiss legal process for pledging art and, as the case may be, enforcing a pledge against art as collateral.

Art loans

Historically, art loans were made on a full recourse basis, so that a lender could look to both the artwork and a borrower's other assets in the event of a loan default. However, there is now a growing trend for non-recourse art loans. These loans can be advanced for the acquisition of art or for more general purposes if the art is already owned by a borrower.

A non-recourse loan in the art lending sphere is one in which the artwork is the sole collateral. If the borrower cannot repay the loan or service interest on the loan, the lender is entitled to take possession of the art, but not to attach a borrower's other assets or to petition for a borrower's bankruptcy.

The process of lending money against art requires careful assessment of the artwork, particularly as to its provenance, ownership, attribution and condition, each of which will affect the value of the

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artwork and thus its lending value. Lenders will want to ensure that their loan is more than collateralised by the value of the artwork, which can lead to loan-to-value covenants that could cut across the non-recourse nature of the loan (eg, requiring a top up in collateral in the event of a fall in value of the artwork or the artwork proving to be counterfeit). The loan documentation can be complex and structured, and careful analysis is required to determine whether a loan is genuinely non-recourse in all circumstances.

Pledging art under Swiss law

Art-secured loans are not a complete novelty in Switzerland, as illustrated by the famous 2005 *Golden coins* case⁽⁵⁾ in the dispute opposing the Union of India and *Crédit Agricole Indosuez SA* or the 2011 case regarding the enforcement of claims secured by bronze statues ultimately found to be counterfeit.⁽⁶⁾

The documentation consists of a loan agreement and a security agreement, which can be the same or separate agreements. Swiss private international law allows for the loan and security agreement to be subject to foreign law. However, to ensure the efficacy of the security enforcement mechanism, it is best to have the security agreement governed by the law where the collateral is located. Given the importance of Swiss free ports and the volume of artworks that they store, this point is particularly important as it may otherwise impair the enforceability of the collateral in case of an event of default. It will also be critical to ensure that the security is perfected in the country where the collateral is located. This may include registration or other notarisation requirements. Where the loan and the security agreements are subject to different laws, coordination among the two is paramount, particularly regarding the adjudication process, with arbitration often being the favoured option.

Under Swiss law, chattels may be pledged only by the transfer of the possession of the pledged chattel to the pledgee (Article 884 of the Swiss Civil Code); a general lien is not established as long as the pledgee retains exclusive possession of the chattel. This is one of the main obstacles to art lending in Switzerland as it means that the owner must physically transfer the artwork to the lender. However, such transfer can take different forms: apart from the direct transfer to the pledgee, the pledged artwork can be held by a third-party depositary (eg, an art gallery, a storage company or a museum) on the pledgee's behalf or the parties can agree that they will jointly exercise possession of the pledged artwork (eg, sharing a key to the same storage facility with equal access). While it is clear that an owner would be unable to enjoy the artwork at home where it is required to be pledged for the purpose of a non-recourse loan, the parties are free to agree a right of use of the pledged chattel by the pledgee and to define its scope. This will be particularly useful for the exhibition of the work in a museum or gallery.

If the borrower is in default, the pledgee can enforce the pledge in the manner described below and satisfy its claim (ie, the principal loan amount, contractual interest, debt enforcement costs and default interest) out of the proceeds of the pledged asset.

Enforcement of art-secured pledge

Despite all of the due diligence regarding the provenance and valuation of a piece of art, no investment is absolutely guaranteed. With non-recourse loans becoming more common and art valuation becoming increasingly volatile, many more art loans are expected to become distressed and result in enforcement measures being taken by lenders. In the context of a Swiss art-secured pledge, two options are available:

- enforcement by forced sale, which is carried out by the Debt Collection Office (DCO); or
- enforcement by private sale as provided under the pledge agreement.

Enforcement by DCO

According to the Federal Act on Debt Enforcement and Bankruptcy (DEBA), the DCO may enforce an art-secured pledge by:

- public auction;
- private sale; or
- a sale organised by a third party.

Public auction

The DCO will generally hold a public auction of a pledged artwork with the aim of selling the property so that the pledgee can be reimbursed (Article 125(1) of the DEBA).

The main advantages of a public auction conducted by the DCO are the related low costs and the fact that the pledgee is not required to take any special steps. However, this procedure has the significant disadvantage of generally resulting in a devaluation of the artwork given the DCO's lack of expertise

in relation to artworks. While this might not be a concern to a lender who is amply over-collateralised, it will be a concern if the realisable value is less than the amount owed to the lender. The borrower is not entitled to object to the choice of proceeding via public auction, but can try to persuade the pledgee to proceed via private sale instead (see below for further details on this option).

Since the Swiss market may not be the right market for certain artworks, the question arises as to whether a sale can be conducted by an auction house abroad. Although the DCO can theoretically commission an auction house abroad to carry out the sale of an artwork, this option is generally excluded due to the risks and costs of transport abroad.

Private sales

Alternatively, under Article 130 of the DEBA, the DCO may carry out a 'private' sale (ie, a direct sale between the DCO and the buyer). However, this type of sale requires the parties' consent, unless the value of the pledged asset is falling rapidly or the cost of safeguarding it is disproportionately expensive.

The private sale has the advantage of targeting a well-informed public and thus reaching a selling price that is possibly closer to the market value of the artwork. However, it has the same disadvantage as a DCO-led public auction given the DCO's lack of expertise regarding artworks.

Sales organised by third party

In exceptional circumstances, such as when the pledged asset is an artwork of great value, the DCO may entrust the sale of the movable property to a third party. In practice, the third party will often be a reputable auction house, so that the sale can be handled by experts and reach as many potential buyers as possible.

Private enforcement

The pledge agreement concluded between the pledgee and the borrower may also reserve a right for the pledgee to proceed by private enforcement, once the claim is due and after having informed the borrower thereof. Such contractual clauses are common in practice. Private enforcement allows the creditor to proceed directly with the sale of the collateral, without involving the DCO (ie, without formal debt enforcement proceedings or court process leading to an enforceable judgment).

The main advantages of private enforcement – including private auction – are the speed, ease of the sale process and, depending on the circumstances, better selling price of the artwork. The main disadvantages are that the creditor will be acting under its name as a direct counterparty to the sale. Accordingly, if the object is affected by defects, it is the pledgee who will be liable to the third-party purchaser. The pledgee must always act with extreme diligence when selling the pledged artwork. In this context, the parties can provide in the pledge agreement that the sale can be conducted by an auction house abroad or by any expert around the world which may be best suited for an artwork of a particular market.

Comment

Concluding an art-based loan agreement under Swiss law offers many advantages, and it will be interesting to see how this particular loan product fares in the aftermath of the COVID-19 crisis. In any event, such deals raise complex questions and require careful consideration. Borrowers and lenders are strongly advised to take advice in reviewing the loan documentation and fully understand the scenarios in which the artwork may be subject to enforcement.

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Endnotes

- (1) Clare McAndrew, *The Art Market 2020*, p 17 available [here](#).
 - (2) Deloitte & ArtTactic, *Art & Finance Report 2019*, 6th ed, p 108, available [here](#).
 - (3) *Id*, p 110.
 - (4) *Id*, p 108.
 - (5) Supreme Court decision dated 8 April 2005, ATF 131 III 418.
 - (6) Supreme Court decision dated 9 November 2011, 5A_551/2011.
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