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Security over Art

An introduction

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A number of particular issues and difficulties arise in taking security over art as opposed to other assets. This briefing paper is a general introduction to the subject, and highlights some traps for the unwary.

Key points

1. in addition to the valuation of the art, due diligence will include issues such as provenance, title, export licences, and a search of the Art Loss Register
2. if the art work changed hands in a jurisdiction under a dictatorship (including occupied territories) it is necessary to consider whether title to the art work could be impugned. For example, there have been a number of holocaust restitution claims affecting art works in recent years
3. where security over art is given by an individual, the Bills of Sale Acts 1878-1882 (the "Acts") mean that it is usually impracticable to take a mortgage or charge
4. it is sometimes possible to avoid the problems arising under the Acts by taking security in the form of a pledge, which depends upon actual or constructive possession of the work of art by the lender
5. the Acts do not apply to companies, but a charge over art by a company incorporated or registered in the UK must be registered under the UK Companies Act 2006 in the usual way
6. realisation of the security will require appropriate advice on the best method of disposal, and may involve issues such as whether or not the art can be moved to another jurisdiction
7. the lender's position needs to be protected if the art is to be loaned out for exhibition
8. the Factors Act and the Sale of Goods Act may affect security over works of art
9. changes to the Consumer Credit Act have brought many more secured loans to individuals within the consumer credit regime and these may include loans secured on works of art.

Valuation and Title

The valuation of, and title to, a work of art offered as security are, of course, key issues. The lender will require valuation advice from one or more specialist valuers, and that advice should consider the provenance of the work of art; that is, its origin and authenticity. In addition, the lender will of course wish to investigate the borrower's title to the work of art. This will include checking that any necessary export licences were obtained on previous dealings with the art, and considering whether any will be required if the security has to be enforced. It will also include checking whether the art work might be vulnerable to a holocaust restitution claim or, indeed, if the surrounding circumstances indicate any other restitution claim.

The lender should also check whether or not the work of art is registered with any register of stolen art. There are various registers – the Art Loss Register in the UK is one example – against which searches can be made, but the coverage of these registers is not complete.

In addition, the lender should consider whether or not there are any ancillary rights over which security can be taken, such as rights against a seller or valuer. Where the borrower is purchasing the art, however, the seller seldom gives an outright guarantee of authenticity, and an auction house is likely to restrict its potential liability by the terms of the auction contract¹.

Form of Security

General

Under English law, the security may be in the form of a mortgage, charge or pledge. The most appropriate form of security is likely to depend on the nature of the security provider, and the location where the art is to be held. A key issue is whether the art is stored by or on behalf of the lender or left in the possession of the borrower. For both legal and obvious practical reasons, a lender requiring watertight security over a work of art is best advised not to leave it in the borrower's possession or control.

Mortgage or charge

A legal mortgage (often referred to in this context as a "chattel mortgage") involves the transfer of legal ownership in the art to the lender, subject to the borrower's right to re-transfer on repayment, and will be contained in a written agreement. The mortgage will be equitable where the borrower's interest in the work of art is itself an equitable one, such as an interest under a trust. An equitable mortgage may also be created where some formality required for a legal mortgage is missing, but this will not always be the case.

A charge involves an agreement by the borrower to give the lender a proprietary interest in an asset as security for a liability. In most cases this is done very simply by the borrower executing a document by which the debtor is expressed to charge a particular asset as security for a particular debt. The distinction between an equitable mortgage and a charge is a narrow one.

There are certain advantages in taking a legal mortgage rather than an equitable mortgage or charge. In particular, an equitable mortgage or charge will generally be overridden by a purchaser in good faith of the legal interest in the art without notice of the lender's security.

¹ The case of *Marie Zelinger de Balkany v Christie Manson & Woods Ltd* (1995) illustrates this point.

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A mortgage or charge over goods may be fixed or floating. In distinguishing between these, similar issues arise to those extensively reviewed by the courts in relation to charges over book debts. In the case of *Re Beam Tube Products Ltd*² the court held that a so-called fixed charge over plant and equipment created only a floating charge. To achieve a fixed charge over goods the lender needs a sufficient control mechanism in the charging document, and to apply that mechanism in practice. An unrestricted right for the borrower to sell or replace the goods without the specific consent of the lender on a case by case basis is likely to render a charge floating. In practice this will seldom be an issue when the security comprises valuable works of art, since the lender will usually insist on these remaining under its possession or control, but the issue should not be overlooked.

Pledge

A pledge is an altogether different form of security. It requires an actual or constructive delivery of possession of the work of art to the lender, and is considered in more detail below.

Lien

A lien is a right to detain goods until money owed has been paid, and may be created by contract, or may arise by implication. An example is the right to detain a work of art which has been restored until the cost of restoration has been paid.

Bills of Sale Acts

A mortgage or charge by an individual or a partnership (other than a limited liability partnership) over “personal chattels” is subject to the Bills of Sale Acts. A work of art such as a painting or sculpture is a personal chattel for this purpose. Unless it falls within one of the very limited statutory exemptions, the security will be void unless it is in the form required by, and is registered under, the Acts. In practice, these formalities are cumbersome and unattractive to lenders, such that taking a mortgage or charge over works of art from an individual is seldom practicable.

The Acts do not apply to security given by a company, although in that case the security will generally require registration at the UK Companies Registry if the company is incorporated in the UK.

If the art is purchased in the name of a company or transferred to a company, in order to enable that company to create a mortgage or charge outside the Acts, the purchase or transfer must be a genuine one, and not a sham arrangement, otherwise the security may be re-characterised as a bill of sale. The risk is increased if an individual controlling the company is left in possession of the charged art.

Similarly, where any financing is structured as the purchase of assets by the person providing finance, the courts will look to the substance of the transaction to determine whether a document is within the Acts, and may disregard the document as a sham if it

was intended to conceal the fact that the transaction was a secured loan.

Pledges

It is sometimes possible to avoid the difficulties caused by the Acts by taking security over works of art in the form of a pledge, rather than a mortgage or charge. Even if given by a company, a pledge does not generally require registration at the UK Companies Registry.

A pledge requires the delivery of possession of the relevant item, or of documents of title to it (which will seldom be relevant in relation to works of art), to the lender, with the intent to create a pledge. The delivery may be constructive; for example by a third party in possession of goods undertaking to the lender to hold them to the order of the lender (a process known as “attornment”). The pledge must, however, arise by actual or constructive delivery of possession, not under a security document. A pledge agreement may regulate the rights of the parties, but if it operates as a written assignment passing title it is likely to be subject to the Acts.

Security held outside England

Particular issues, too numerous to be covered fully in this note, arise when the works of art are located abroad. The general principle is that whether or not effective security is created will be governed by the law of the place where the work of art is located at the time. Local legal advice is needed to check whether or not security under English law will be effective – it will often not be – and also what local formality, stamp and registration requirements apply.

Many jurisdictions are hostile to any form of security leaving art in the possession of the borrower (often referred to, in the case of a mortgage, as a “non-possessory chattel mortgage”), given the increased risk of concealment, fraud and the possible impression of false wealth by the borrower. “Debtor friendly” local law or practice may also make recovery or enforcement difficult or time-consuming. A borrower left in possession of valuable works of art may be able to move them rapidly to a jurisdiction where recovery will be extremely difficult.

Realisation of the Security

Specialist advice is required on the appropriate means of enforcing the security, and on issues such as whether or not an export licence is required on a disposal.

A challenge by the borrower that “the best price reasonably obtainable” has not been achieved is perhaps particularly likely when the security comprises valuable paintings or other works of art. From the lender’s perspective, disposal at auction is often safer than a private sale, although a borrower might still claim that the chosen auction house, timing or reserve price was

² [2006] EWHC 486 (Ch).

inappropriate. Moreover, if a painting fails to reach its reserve price at auction, this can have a dramatic effect on value, making it more difficult to sell the painting privately. However, a challenge by the borrower on the ground that the disposal should have been delayed to allow an improvement in the market is unlikely to succeed under English law.

If the valuation advice is that the best price is likely to be achieved by sale at auction in another jurisdiction – for example that a painting held in England should be put into an auction in New York – advice is needed on whether or not the lender’s security will remain effective when the painting is exported. The advice should also cover any particular obligations under local law as to the means of disposal, local filing requirements, and any notice period which must be given to the borrower before a disposal.

Loans of Art

Some of the issues mentioned above are also relevant if the borrower wishes to lend a work of art which is subject to security for display in an exhibition, particularly where the gallery or museum where the art is to be exhibited is outside England³. A major exhibitor may have its own forms of documentation and procedures, but if the art is subject to security, a security holder willing to agree to the art being loaned out needs to be satisfied that its security will remain effective and is held to its order. If the exhibition is in another jurisdiction it may be necessary to take additional security in the appropriate local form. Insurance and security of the art also need to be considered. The exhibitor may be paying a fee to the borrower, but the security holder seldom requires security over this unless it is substantial.

Possession of the art

As mentioned above, a lender requiring watertight security over art is well advised to take actual or constructive possession of it. However, owners of art works are often keen to display them in their own homes and in this situation, the lender has to decide whether this can be accomplished.

As a general rule, no one can transfer a better title to goods than he himself possesses (this is the *nemo dat quod non habet* rule). It follows that a purchaser cannot generally acquire any better title to goods than that of a seller who does not own the goods. Likewise, a good faith purchaser who acquires goods from a mortgagor wrongfully selling such goods does not generally obtain priority over a prior legal mortgage. In two situations, however, it is possible for a bona fide purchaser of goods without notice to acquire title to such goods from a third party which has priority to the title of the owner/mortgagee. These are:

- a. where the owner has by his conduct held out a third party as having authority to sell the goods or as being the owner of the goods; and

- b. where the owner gives possession of the goods (or documents of title) to a mercantile agent and the agent disposes of such goods in the ordinary course of its business.

The fact that a lender allowed the owner or a third party to retain possession of mortgaged art would not, of itself, amount to the lender holding out that the owner or third party was the owner or had authority to sell such art, but if the third party was a gallery (whose business was to buy and sell art) the mercantile agent exemption (set out in (b) above) could apply.

If a borrower managed wrongfully to take the art outside England and Wales, the risk to the lender of defeat of its mortgage is significantly greater as the law of the jurisdiction in which the art is situated would apply and such law may well not recognise an English law chattel mortgage.

So where does this leave a lender? The risk to the lender is potentially twofold. First, art is often portable and there is a risk that prior to enforcement it disappears. Secondly, in certain limited circumstances an innocent third party (e.g. a purchaser or another lender) could defeat the lender's mortgage. A lender thinking of permitting an owner or third party to retain possession of the art therefore needs to be comfortable about the integrity of the owner or third party. A lender needs to take special care if it allows the art work to be held by a gallery which could be regarded as a mercantile agent and will need to be comfortable about the integrity and reputation of the gallery which should be truly independent of the owner. In order to mitigate the risks, lenders should consider tagging the art, should always register their interest in the Art Loss Register and should reserve rights to inspect the art at regular intervals and to give themselves the right to require the art to be delivered into their possession at any time and certainly after the occurrence of an event of default.

Consumer Credit Loans

Security, including for this purpose a guarantee, for a loan within the Consumer Credit Act 1974 is subject to a number of additional requirements.

The security must be in writing, adopt the prescribed form, and embody the prescribed contents. If it is provided by the borrower, the terms of the security must be set out in the credit agreement, or a document it refers to. Unless these and numerous other formalities are observed, the security document is not properly executed, and is enforceable only with a Court Order. There are also detailed rules about the statements and information to be supplied to the borrower, about default, enforcement and termination, and concerning the pledge (or pawn) of goods under a regulated agreement.

³ A somewhat different issue – immunity from seizure for items lent to the UK from overseas for temporary exhibition - is dealt with in the Tribunals, Courts and Enforcement Act 2007.

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All loans to individuals, and to many small partnerships and unincorporated associations, are likely to be caught, subject to certain exemptions. These include loans to certain high net worth individuals where the credit exceeds £60,260 and loans exceeding £25,000 made for predominantly business purposes, subject in each case to the appropriate procedures being followed.

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