

Security over Art

September 2017



Introduction

Although there is no shortage of borrowers in the market, many lenders have not had a large appetite for funding works of art because of a number of factors including:

- issues of authenticity and the risk of the art being a forgery;
- the identity of the art;
- the portability of the art;
- the archaic method of taking security over art from an individual under English law;
- the possibility of a challenge to title, e.g. a holocaust restitution claim;
- there is no compulsory art register in the UK, unlike other assets, e.g. real estate and aircraft; and
- there is no real equivalent to UCC-1 filings in the UK so that registration of an interest in art in the UK is a little hit and miss.

Having said all that, there are ways for a lender to overcome many of these issues and obtain valid and effective security over the art which are discussed below.

Key points

1. In addition to the valuation of the art, due diligence will be required to cover 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 in World War II) it is necessary to consider whether the owner's title to the art work could be impugned. For example, there have been a number of holocaust restitution claims affecting works of art in recent years.
3. Subject to 4 below, where security over art is given by an individual who retains possession of the art, the Bills of Sale Acts 1878-1882 (the "Acts") mean that it is usually impracticable to take a mortgage or charge. However, the Goods Mortgages Bill which is currently before Parliament, will streamline the process and may make lenders more willing to lend in these circumstances.
4. It is 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 mortgage or 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 to achieve the best price.
7. The lender's position needs to be protected if the art is to be loaned out for exhibition.
8. The Factors Act 1889 and the Sale of Goods Act 1979 may affect security over works of art.
9. A loan to an individual secured on works of art may constitute a regulated credit agreement and be subject to the UK consumer credit regulations.

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. Valuations can be problematic in that the art world is very small and owners can be concerned about confidentiality. In addition, the lender will of course wish to investigate the borrower's title to the work of art. Ownership of the art needs to be traced from birth to its acquisition by the current owner. This will also 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 possible 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 and registration of claims at the Art Loss Register (whilst common practice) is not compulsory.

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. Other forms of security such as a sale and leaseback could also be considered.

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

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

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.

A mortgage or charge over goods (e.g. works of art) may be fixed or floating. 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 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 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.

A new bill, called the Goods Mortgages Bill, is currently before Parliament. Its purpose is to replace the Victorian-era Acts to enable individuals to use their existing goods (such as art or vehicles) as security for a loan, while retaining possession of the goods. The new Act will streamline the procedure for taking security, increase the protection of borrowers who get into financial difficulties (subject to an opt out for high net worth individuals), prevent a lender breaking into private property to repossess goods without a Court order and provide protection to an innocent private purchaser buying goods (especially vehicles) which are subject to security. The current proposals, however, do not go as far as creating a registration system comparable to the UCC system in the United States. As of the date of this briefing, the new bill is expected to come into force before 2019.

Pledges

It is 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.

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.

The effect of a pledge is that the borrower retains ownership of, and title to, the works of art, but the lender takes possession of it (whether actual or constructive). In other words, a pledge does not allow for the work of art to be kept by the borrower in his or her home.

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 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 (i.e. UCC 1 filing in the relevant state), and any notice period which must be given to the borrower before a disposal.

Insurance

It is important for the lender to ensure that the art which stands as security is insured against all risks for the full value of the art. The lender may wish the insurance cover to be in the joint names of the borrower and the lender or with the lender being named as composite insured. It will also wish to be named as loss payee and have other protections e.g. the insurance policy not lapsing for non-payment of premium without notice being given to the lender. In addition, a lender would wish the insurance policies to be assigned to it so that the lender’s interest in the proceeds of the policy would withstand attack from a trustee-in-bankruptcy or liquidator.

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 England. 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 and registration

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 there is no statutory provision that registration under the UK companies legislation or the UK bills of sale legislation is deemed to constitute actual notice, the mere fact of registration under the Companies Act 2006 or the Acts will not, of itself, mean that a third party dealing with a borrower is deemed to have actual notice of what is registered. It is necessary to consider whether a person would have constructive notice of a registration at the Companies Registry or under the Acts, i.e. whether a person buying art or taking security over art from the borrower ought reasonably to have searched the relevant registries. In the case of buyers, it is unlikely that they would be deemed to be fixed with constructive notice of registration. In the case of bank lenders, it is likely that they would be fixed with constructive notice.

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.

Generally, a lender with a duly perfected pledge or chattel mortgage over art would not lose its priority to a subsequent mortgagee or chargee or a purchaser, except in the very limited circumstances described in a) or b) above or if the art is taken abroad, as described immediately below.

Please see above, however, under the heading “Bills of Sale Acts”. If the Goods Mortgages Bill is enacted as currently drafted, in addition, a private purchaser without notice of the lender’s security, could defeat the lender’s security.

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 very 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 security where they can (e.g. at the UK Companies Registry and the High Court if applicable) and always register their interest in the Art Loss Register. They should also 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.

Regulated Credit Agreements

Loans to individuals, and to small partnerships and unincorporated associations, must be considered in the context of the UK consumer credit regulations to determine whether they are regulated credit agreements, in which case they will be subject to various requirements and restrictions prescribed by law, or if an exemption is available which would take the loan outside the scope of the consumer credit regulations. The most commonly used exemptions include the high net worth exemption (the loan must exceed £60,260 and be for a purpose other than renovation of residential property, or to acquire or retain property rights in land or in an existing or projected building) and the business exemption (for loans exceeding £25,000 made for predominantly business purposes) and are subject in each case to the appropriate

procedures being followed.

This briefing is intended only as a guide and does not constitute legal advice. We would be please to provide more detailed advice if required.

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Contacts



Andrew Evans

Partner - Finance - London

E: Andrew.Evans@fieldfisher.com

T: +44 (0)20 7861 4169

M: +44 (0)7780 997 043



Oliver Abel Smith

Partner - Finance - London

E: Oliver.AbelSmith@fieldfisher.com

T: +44 (0)20 7861 4855

M: +44 (0)7917 769 248



Matt Hinxman

Partner - Finance - London

E: Matt.Hinxman@fieldfisher.com

T: +44 (0)20 7861 4122

M: +44 (0)7977 151 226



Helen Mulcahy

Partner - Dispute Resolution - London

E: Helen.Mulcahy@fieldfisher.com

T: +44 (0)20 7861 4993

M: +44 (0)7818 573 272



Hannah Rowbotham

Director - Finance - London

E: Hannah.Rowbotham@fieldfisher.com

T: +44 (0)20 7861 4649

M: +44 (0)7725 619 636



Lisa Harrison

Senior Associate (Australian Qualified) - Finance - London

E: Lisa.Harrison@fieldfisher.com

T: +44 (0)20 7861 4048