



ART, AUCTIONS & ANTIQUES

By **Megan E. Noh**

Selling Artwork in a Turbulent Economy

Consignor protections and potential treatment in bankruptcy

Given the distressed economy in which art businesses are currently operating due to the global COVID-19 pandemic, galleries and auction houses are likely to be at greater risk of becoming insolvent. Artists and art collectors may be surprised to discover that they have different rights, depending on their connections to the consigned artwork, the types of consignees with whom they're doing business and the locations of their consignments. Let's review several key factors that inform the availability of statutory, common law and contractual protections to consignors, and the extent and impact of those protections in the event of a consignee's bankruptcy.

A Difficult Year

More than a year into the global COVID-19 pandemic, the art market has undergone significant adjustments, including the widespread use of online viewing rooms for fairs and gallery exhibitions and the adoption of online simulcast formats for live auctions.¹ Still, the delayed vaccination roll-out and the emergence of new virus variants further complicate the timeline for returning to art world activities that were commonplace pre-COVID, including gathering in person for premier evening sales and related promotional events.

While the top end of the art market generally "tough[ed] it out" in 2020,² the distress of smaller art businesses (including galleries and brokers) is likely to have broader long-term impacts. Unfortunately,

the market's relative opacity and the privately held status of many of its major players make it difficult to see a comprehensive picture of potential consignment partners' financial conditions. If a basic lien search reveals no red flags, a would-be consignor must rely largely on market scuttlebutt.³ In some cases, a consignor's first inkling of a consignee's financial distress is the latter's failure to timely remit proceeds—or worse, the rude awakening of a bankruptcy filing itself.⁴

Heightened Consignment Risks

Sellers of fine art—particularly those with fiduciary obligations—must consider the heightened risks of consignment in this climate, including the possibility that a consignee will seek bankruptcy protection and the impact of such an event. A consignor's avenues for protection depend on a number of questions, including:

- **Who created the artwork(s) being consigned?** Certain statutes offer increased protections to artists who consign their own property (and in some cases, their successors-in-interest), as compared to non-artist consignors.
- **What's the nature of the consignee's business?** For property consigned to certain art merchants, a consignor may be able to file a protective financing statement under Article 9 of the Uniform Commercial Code (UCC)—but for auction consignments, this path is less clear.
- **What's the location of the consignment?** State laws vary widely, including with respect to the type(s) of consignors eligible for special protections, notice requirements vis-à-vis a consignee's creditors and the obligations of consignees to undertake trust accounting.

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Bankruptcy and UCC Basics

A fundamental objective of bankruptcy law is the protection of creditors from so-called “secret” liens—interests in a debtor’s property that couldn’t reasonably have been known to its creditors. In certain cases, a consignor may perfect a security interest in consigned goods by complying with provisions of the UCC for the filing of a financing statement, which puts the consignee’s creditors on notice of such interest.

However, if a consignor fails to do so and the consignee becomes the debtor in a bankruptcy case, the consignee may obtain the “rights and title to the goods identical to those the consignor had”⁵ and then transfer those interests to its creditors (this legal process is known as “attachment”).⁶ In such a scenario, the consigned artwork becomes part of the “bankruptcy estate,” meaning that it’s no longer recognized as separate property of the consignor, and the consignor will be relegated to the status of a general creditor.⁷

Moreover, while perfection of a security interest may protect the consignor’s interest in the property itself, it doesn’t necessarily protect the consignor’s interest in the sale proceeds of that property. This risk is exacerbated by the policy preference in bankruptcy of favoring equal treatment of creditors. Typically, this is accomplished through a pro rata distribution of available debtor funds, so that creditors recover on an equal basis from the available pool of assets—often at pennies-on-the-dollar—rather than receiving preferential treatment over other similarly situated creditors.

Even a diligent consignor may have trouble determining whether a consignment is eligible for the perfection of a security interest, because the interpretation and application of the UCC consignment provisions have a fraught history and continue to result in judicial confusion.⁸ Prior to 2001, certain consignments were governed by Article 9 of the UCC (under which the consignor could be recognized as having a perfected security interest) and others by Article 2 (under which the arrangement might be deemed a “sale or return,” giving rise to no equivalent interest).⁹

In 2001, certain revisions to the UCC took effect in most states, including the articulation

of a narrower definition of “consignment” under Article 9 and the removal from Article 2 of rules governing other consignments. The drafters’ intention was to afford protection to more consignors under Article 9 and for non-Article 9 consignments (sometimes called “common law” or “true” consignments¹⁰) to be governed by the common law of bailments.¹¹

However, because the drafters opted not to remove the “sale or return” language from Article 2, some courts erroneously continued to operate on the assumption that consignments must be classified as falling under *either* Article 9 *or* Article 2. They’ve applied the latter (rather than common law) to art consignments not falling squarely under Article 9’s definition.¹² As discussed below, this narrowed definition may be of particular significance in its exclusion of certain consignment types and underscores the importance of giving careful consideration to the contextual specifics of a proposed consignment.

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Who’s the Consignor?

When the consignor of an artwork is the artist who created it, special statutory protections may apply, including the automatic status of the merchant as a fiduciary. In New York, artist-consigned property and its proceeds are held in “trust ... in the hands of the consignee” for the artist’s benefit.¹³ As a result, the artist’s interest in the artwork may not be “subordinate[d] to any claims, liens or security interest[s] of any kind or nature whatsoever of the consignee’s creditors.”¹⁴

New York’s Arts & Cultural Affairs Law (ACA) was amended to provide its current enhanced benefits to artist-consignors as a result of advocacy¹⁵ following the 2007 bankruptcy of the prominent Salander-O’Reilly gallery, in which it came to light that the gallery had failed to pay artists and their



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heirs nearly \$120 million in sale proceeds.¹⁶ Over 30 other states have enacted similar artist protection statutes.¹⁷

The ACA provides an artist-consignor with the equivalent of a super-priority with respect to the actual artwork property. But, this shield is less bulletproof as applied to the sale proceeds owed to the artist. The statute requires art merchants to establish separate trust accounts and provides that the failure to do so is a breach of duty subject to penalties set forth in the New York Estates, Powers and Trusts Law.¹⁸ Yet, practically speaking, when an art merchant improperly commingles artist-consignor proceeds with its own funds prior to declaring bankruptcy, the artist-consignor may still wind up in a difficult position. As the old saying goes, one can't "get blood from a stone"—if the merchant has already disbursed the funds that should have been held in trust, the artist-consignor is unlikely to recover the full amount of net proceeds due.

The intricacies of the UCC consignment provisions are compounded by inconsistent judicial application and by the material differences in state common law precedent and statutory provisions on agency relationships and consignor protections.

New York's artist-consignor protections may apply to an artist's successors-in-interest¹⁹ but will generally not be applicable when the consignor of artwork is a primary or secondary market purchaser (or the heir or other beneficiary thereof). However, the ACA operates independently from the

Article 9 financing statement process, which may still be available to non-artist consignors, depending on the nature of a consignee's business. Other state consignment statutes may also protect a broader class of consignors than the ACA.²⁰ Determining what protections are available thus implicates the other two factors mentioned below.

What's the Consignee's Business?

When a consignee is a gallery in the business of selling art²¹ and is known to sell its own inventory,²² and the consigned property isn't reasonably categorized as "consumer goods immediately before delivery"²³—as is arguably the case for artwork being consigned by a trust or estate, if it was previously personal property of the decedent or grantor—the consignment may qualify under Article 9 for perfection of the consignor's security interest. Although there are relevant filing, notice and timing requirements, no contractual grant is required to give rise to such an Article 9 interest.

By contrast, when a consignee is an auctioneer, the arrangement is expressly excluded from Article 9's definition of "consignments" for which a financing statement is meant to be filed.²⁴ An auction consignor may consider seeking to bootstrap such a consignment back into Article 9's ambit by requiring the auctioneer to grant a precautionary purchase money security interest (PMSI) in the consigned property and the net proceeds due under the consignment agreement. While the filing of a precautionary statement noticing the auctioneer's creditors of such a purported interest is unlikely to be practically detrimental to the consignor, the legal impact of such a filing is unclear in the absence of robust legal precedent on the treatment of precautionary PMSIs in the auction context.

Where's the Consignee Located?

In the absence of a PMSI (or if a PMSI is found to be ineffective), an auction consignor may seek to rely on a constructive trust theory—asserting that the debtor doesn't hold equitable title to artwork in its possession because that property is held constructively in trust for the benefit of the consignor.²⁵ Bankruptcy courts apply state law to determine the nature and extent of a debtor's interest in property.

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This factor may thus be summed up as: location, location, location.

Some states have developed common law precedents as to the role of an auctioneer. For example, in *In re Martin Fein & Co.*, the Bankruptcy Court for the Southern District of New York acknowledged that New York common law imposes an agent-principal relationship between auctioneers and their consignors as a matter of law, continuing through the sale of the property until the auctioneer has remitted the net proceeds due to the consignor. As a result, the *Fein* court held that even when an auctioneer fails to segregate consignor proceeds, the consignor may benefit from the imposition of a constructive trust.²⁶ Such a finding, however, is maddeningly state-specific: While one bankruptcy court has held that an auctioneer's agency may be presumed under New Jersey law even when a consignment contract is oral,²⁷ other courts have applied Nebraska and Oregon law to find that the agency relationship may terminate even under a written consignment agreement if the parties didn't specifically document the auctioneer's obligation to segregate funds.²⁸

Auctioneers in other states, such as California and Washington, have statutory obligations to undertake consignor trust accounting.²⁹ Moreover, as noted above, state consignor protection statutes applicable to both gallery and auction consignments vary widely: In addition to potentially protecting a broader class of consignors than just artist-consignors, they may supplant the requirement to file a UCC-1 financing statement or create an alternative to such requirement.³⁰

It's critical, therefore, for a consignor to understand which state's law will govern a proposed consignment and to bear in mind that even when that law may impose a statutory or constructive trust, the reality is that any pot of commingled funds is still likely to be shared with other similarly situated consignors.

Consignor Best Practices

The intricacies of the UCC consignment provisions are compounded by inconsistent judicial application and by the material differences in state common law precedent and statutory provisions on agency relationships and consignor protections. Given this

complex and confusing landscape, fiduciaries considering the consignment of artwork should be cognizant not only of the importance of conducting available diligence on prospective consignees and taking full advantage of available statutory notice provisions but also of exploring the use of protective contractual protections.

When consigning property to a gallery, a consignor should strongly consider filing a UCC financing statement in the state where the gallery is formed and ensuring the priority of that interest by delivering the requisite notice to the gallery's other relevant creditors prior to placing the consignment property in the hands of the gallery or its agents.³¹ Alternatively, the would-be consignor may prefer to structure the transaction as an agency rather than a consignment, permitting the gallery to broker sales *without* taking possession of the property. In addition, the use of a third-party escrow agent for the receipt and disbursement of purchase funds may provide enhanced security.

It's always prudent for fiduciaries to consider the impact of market conditions on their transactional risks and to attempt to mitigate those risks in light of available legal and practical options.

When consigning artwork for sale by auction, a consignor should inquire about the auctioneer's financial health and use of segregated accounting. Where the latter isn't available, the consignor may consider negotiating to include protective language in the consignment agreement, such as provisions establishing the auctioneer's express duty to hold and remit net proceeds in its capacity as the consignor's agent, granting the consignor a precautionary PMSI and/or reducing the time period during which the auctioneer is permitted to hold the consignor's net



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proceeds following receipt of purchaser funds.

Although the long-term impact of COVID-19 on the art market remains to be seen, the March 2020 Paddle8 bankruptcy hasn't yet proved to be the harbinger of additional art world bankruptcy filings that was feared.³² Still, it's always prudent for fiduciaries to consider the impact of market conditions on their transactional risks and to attempt to mitigate those risks in light of available legal and practical options. 🌀

— *The views and opinions expressed in this article are those of the author individually, and not in her role as Trustee; they do not constitute legal advice nor necessarily reflect the position of Pryor Cashman LLP.*

Endnotes

1. See Anna Brady, "Art market 2020: the year of cancel culture and bricks-and-clicks," *The Art Newspaper* (Nov. 25, 2020), www.theartnewspaper.com/analysis/year-of-cancel-culture-and-bricks-and-clicks.
2. See Chris Carter, "The Art Market Managed to Tough it Out in 2020," *MoneyWeek* (Dec. 24, 2020), <https://moneyweek.com/investments/alternative-investments/602516/art-hangs-tough-in-2020>.
3. It should be noted that even publicly released financial disclosures may be subject to overblown perception of bankruptcy risk. In May 2020, Deloitte released a statement regarding one of the major auction houses for whom it performed external auditing and which during the reporting period had been publicly held. The statement that Sotheby's is "unable to predict ... [its] ability to meet [its] obligations when they become due ... over the next twelve months" caused alarm in the marketplace, see, e.g., Marion Maneker, "Should We Be Worried About Sotheby's Ability to Meet Its Obligations?" *Art Market Monitor* (May 4, 2020), www.artmarketmonitor.com/2020/05/04/should-we-be-worried-about-sothebys-ability-to-meet-its-obligations/. Yet as of the time of writing, Sotheby's is performing strongly and hasn't sought bankruptcy protection. See Eileen Kinsella, "Top Auction Houses Saw Total Sales Drop in 2020—But Sotheby's Outpaced Rival Christie's With \$5 Billion in Revenue," *Artnet News* (Dec. 18, 2020), <https://news.artnet.com/market/sothebys-and-christies-drop-in-auction-as-private-sales-thrive-1932780>.
4. See Helen Holmes, "One Week After Being Sued, Online Auction House Paddle8 Has Filed for Bankruptcy," *Observer* (March 18, 2020), <https://observer.com/2020/03/paddle8-bankruptcy-auction-house> (discussing continued assurances by debtor that it was making "arrangements" to pay out its consignors and the surprise bankruptcy filing following commencement of civil suit for non-payment); see also Gareth Harris, "Online Auction House Paddle8 Files for Bankruptcy," *The Art Newspaper* (March 18, 2020), www.theartnewspaper.com/news/online-auction-house-paddle8-files-for-bankruptcy.
5. Uniform Commercial Code (UCC) Section 9-319(a).
6. See also Willa Gibson, "Untangling the Web of Consignment Law: the Journey from the Common Law & Article 2 to Revised Article 9," 10 *Wm. & Mary Bus. L. Rev.* 1, 25 (2018).
7. See generally Hilary Jay, "A Picture Imperfect: The Rights of Art Consignor-Collectors When Their Art Dealer Files for Bankruptcy," 58 *Duke Law J.* 1859 (2009). This may be the case even when the underlying consignment agreement provides that title to such property won't transfer to a purchaser before the consignor's receipt of sale proceeds (and won't transfer to the consignee at all).
8. See Gibson, *supra* note 6, at pp. 6-7.
9. See Michael Madigan, "Orphaned Art Consignors: Confusion in the Courts and the UCC," 29 *Cardozo Arts & Ent. L.J.* 753, 762-65 (2011). The fundamental difference in treatment under the two Articles was in particularly high relief in the art trade, given the prevalent practice of a consignee returning works to a consignor if unsold during the consignment term. That practice could easily be characterized as a "sale or return" under Article 2, resulting in the consignor's property and sale proceeds, with few exceptions, being subject to the creditors' claims. *Ibid.*, at p. 765.
10. See Gibson, *supra* note 6, at pp. 8-9 (noting that the title used to describe a parties' contractual relationship isn't dispositive and that a court will examine the actual nature thereof; further noting that a true consignment "creates a bailment agency relationship with the consignor as the principal and the consignee as agent" for the sale of the consignor's property).
11. See Reporter's Notes, Revision of Uniform Commercial Code Article 2, Nat'l Conf. of Comm'rs on Uniform State Laws, at p. 66 (March 2000), www.law.upenn.edu/bll/archives/ulc/ucc2/2300.htm.
12. See Permanent Editorial Board for the Uniform Commercial Code, Commentary No. 20: Consignments, at n. 22 (Jan. 24, 2019) (describing *In re Morgan-son's Ltd.*, 302 B.R. 784, 790 (Bankr. E.D.N.Y. 2003) as "miss[ing] the essential point" of the 2001 revisions by "mistakenly [concluding] that a person who is considered a consignee is a 'buyer for resale'").
13. New York Arts & Cultural Affairs (ACA) Law Section 12.01 1.(a)(ii)-(iii).
14. *Ibid.* Section 12.01 1.(a)(v).
15. See Association of the Bar of the City of New York, "Report by the Art Law Committee Recommending Amendments to Articles 11 and 12 of New York Arts and Cultural Affairs Law" (July 2010), www.nycbar.org/pdf/report/uploads/3_20071866-CommentsOnArticles11and12ofNYArtandCulturalAffLaw.pdf.
16. See Megan Haslach, "Consignment Catastrophes: Lessons from New York's Art Gallery Fraud," 10 *Wash. J. of Law, Tech. & Arts* 125, 126-27 (2014) (also noting Berry-Hill Gallery bankruptcy); see also Jay, *supra* note 7.
17. Erin McGowan, "Artist-Gallery Consignment Statutes," St. Louis Volunteer Lawyers and Accountants for the Arts (2013), <https://vlaa.org/artist-gallery-consignment-statutes/>.
18. N.Y. ACA Section 12.01 2 (cross-referencing N.Y. EPTL Section 11-1.6, violation of which is a misdemeanor).

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19. N.Y. ACA Section 12.01 1(a), 11.01 20 (extending benefit of protection to heirs, trust beneficiaries, testamentary beneficiaries and personal representatives).
20. See, e.g., Mass. Gen. Law Title XV, Ch. 104A, Section 4 (deeming fine art consignments to be held in statutory trust as that term is contemplated by Bankr. Code Section 541, regardless of the identity or type of the consignor), Mich. Compiled Laws, Ann. Section 442.312 (exempting artwork consigned by an “artist or other person” from the “claims, liens, or security interest[s] of creditors of the art dealer”).
21. UCC Section 9-102 (20)(A)(i) (noting that qualifying consignments must be made to a merchant that “deals in goods of that kind” and sells them under a different name than that of the consignor).
22. *Ibid.* at Section 9-102 (20)(A)(ii) (noting that the consignee must “not [be] generally known by its creditors to be substantially engaged in selling the goods of others”). Some scholars have pointed out that even though galleries are far more likely to be selling inventory or stock (that is, gallery-owned artwork property), consignments to galleries are still susceptible to an argument that galleries are also “generally known” to accept and offer property on consignment. See Jay, *supra* note 7, at p. 1874; Madigan, *supra* note 9, at pp. 777-78.
23. UCC Section 9-102 (20)(C).
24. UCC Section 9-102 (20)(A)(ii).
25. 9A Am. Jur. 2d. Bankr. Section 1225.
26. See two decisions on motions of different creditors of the same auctioneer debtor: 34 B.R. 333 (S.D.N.Y. Bankr. 1983) and 43 B.R. 623, 628 (Bankr. S.D.N.Y. 1984); see also *Cristallina S.A. v. Christie, Manson & Woods Int’l, Inc.*, 117 A.D.2d 284, 292 (Sup. Ct. N.Y. Cty. 1986) (recognizing fiduciary duty of auctioneer to consignor). Note that a consignor seeking to benefit from a constructive trust still has the burden of tracing the trust funds, which may be defeated when a consignee’s commingled account has dipped below a zero balance. See *Sonnenschein v. Reliance Ins. Co.*, 353 F.2d 935, 936-37 (2d Cir. 1965) (citing 4 *Collier on Bankr.* P 70.25[2] at 1215-17, 1218 (14th ed. 1964)).
27. See *McMakin v. Pine Bush Equip. Co.*, 242 B.R. 271, 277-78 (D.N.J. 1999) (finding that under New Jersey law, “the relationship between an auctioneer and a seller of goods is one of agent and principal,” including “at the time of the collection of the proceeds of the auction sale” unless the agency is earlier terminated, and remanding to bankruptcy court for necessary factual findings as to parties’ intent).
28. *In re Rine & Rine Auctioneers*, 74 F.3d 854, 859-60 (8th Cir. 1996) (applying Nebraska law to hold that auctioneer’s transfer of commingled funds to consignor was a voidable preference because the funds weren’t traceable) and 74 F.3d 848 (8th Cir. 1996) (auctioneer wasn’t an agent at the time that proceeds were held in commingled account); *In re Walker Indus. Auctioneers*, 38 B.R. 8, 11-13 (Bankr. D. Or. 1983) (applying Oregon law to hold that agent-principal relationship terminated on sale of consigned property such that agent converted to a creditor and accordingly finding that pre-petition payment of proceeds within look-back period constituted impermissibly preferential transfers). Compare *In re Farrell & Howard Auctioneers*, 172 B.R. 712, 716 (D. Mass. 1994) (finding under mixed-circuit precedent that when “contract imposed no obligation to segregate ... proceeds or hold them in trust,” the “parties’ relationship following the auction was that of debtor and creditor rather than trustee and beneficiary”).
29. See Cal. Civ. Code, Title 2.95, Section 1812.600(j); Wash. Rev. Code, Title 18, Section 18.11.230. Notably, New York has no such requirement.
30. Compare Fla. Stat. Ann. Section 686.502 (noting that consigned property is “held in trust by the consignee for the benefit of the consignor,” but requiring consignor to “give notice to the public” by posting a sign or affixing a tag stating that the work is on consignment), N.J. Stat. Ann. Section 12A:2-330 (similarly requiring consignor to file UCC financing statement or “place[] a sign on the ... work of fine art which states that the item is on consignment”).
31. See Gibson, *supra* note 6, at p. 27 (citing *Arthur Glick Truck Sales, Inc. v. Stephen E. Corp.*, 914 F. Supp.2d 529, 542 (S.D.N.Y. 2012)). Note that when confidentiality of a consignor’s identity is a concern, the consignor may engage a third-party vendor to act as the agent to the secured party of record, thereby preventing the consignor’s name from appearing in the public filing.
32. See Nicholas O’Donnell, “Paddle8 Bankruptcy a Harbinger in the Time of COVID19 and the Coming Art World Crisis,” *ArtFixDaily* (March 24, 2020), www.artfixdaily.com/artwire/release/4752-nicholas-odonnell-paddle-8-bankruptcy-a-harbinger-in-the-time-of-.



SPOT LIGHT

On Track

International Automobile Show by Bernard Brussel-Smith sold for \$1,375 at Swann Auction Galleries Vintage Posters sale on

Feb. 18, 2021 in New York City. In addition to his impressive illustrations as a commercial artist, the New York City-born Brussel-Smith was also a wood engraver, as wood was a medium he enjoyed working with for nearly 50 years.