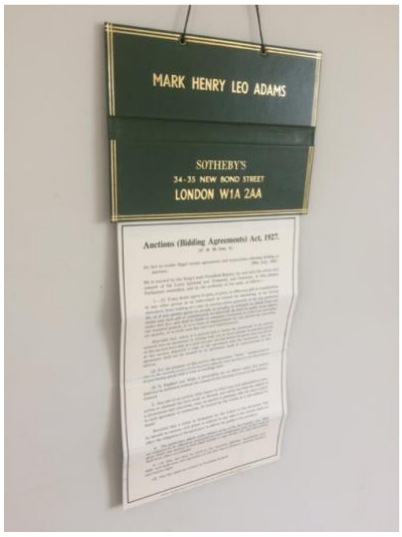
COCHRANE ADAMS
FINE ART AGENTS

Chapter 1

Buyer (And Seller) Beware – The Perils of the Auction Guarantee

By Mark Adams

When I was still a very junior specialist at Sotheby's in the early 1990s, I committed one of the cardinal sins of the auction room: I became confused while executing a telephone bid and failed to win the lot upon which my bidder in Dublin had set his heart. Aghast at my mistake, I performed some rapid client service triage. Thinking fast, I promised him that when he next bid with us I would arrange for him to pay a reduced Buyer's Premium (fixed at a paltry 10% in those far off days).



The subsequent post-mortem involved a meeting with Sotheby's general counsel, a wise and pugnacious man named Jo Och who had fled to the West from Czechoslovakia as a teenager after the Prague Spring of 1968. Jo left me under no illusion that what I had just suggested to my client was unambiguously illegal. It was made clear to me that English law dictated that the integrity of auction depended on offering a level playing field to all comers, and that anything which gave an advantage of any kind to one bidder over another was not only ethically wrong but was in direct violation of the Auctions (Bidding Agreements) Acts of 1927 and 1969.

In due course, having miraculously survived this and other early professional disasters, I became an auctioneer myself. My licence physically incorporated several excerpts from the 1927 Act and the law required that it be hung on the front of my rostrum in full view of the bidding public whenever I held a gavel in my hand.

All of this legislation was framed to protect the central principle upon which the process of auction stands: its transparent fairness. All parties compete equally and the highest bidder wins. It is, or should be, as simple as that. Since the Greek historian Herodotus first described the process by which the Illyrian tribes of the Babylonian Empire sold wives in the 5th century BCE, and the Praetorian Guard held what is arguably the first blockbuster sale in history when they auctioned the Roman Empire in 193CE (the successful bidder, Didius Julianus, paid 25,000 sesterces and survived two months on the throne before meeting a bloody end), the principle of auction has lain at the heart of human commercial interaction for very good reasons.

Edwin Long (1829-1891)
The Babylonian Marriage Market, 1875
Coll. Royal Holloway College, University of London

Auction is fundamentally and evidently *fair*, this fairness being guaranteed by the simplest possible means: the public gaze. There are no backroom dealings: everything is conducted in the open. UK legislation has striven consistently and energetically to combat anything that prejudices this principle, even stipulating until the 1960s that auction sales may not take place outside the hours of daylight. With this in mind, we should describe the workings of an auction guarantee. At its simplest, the guarantee is a mechanism offered to a seller by an auction house which eliminates the risk of a failure to sell: in essence, the auction house underwrites the sale in exchange for an increased fee. If no public bidding emerges, the auction house undertakes to buy the offered lot itself, at a figure around the reserve price which has been negotiated between house and seller.

This may be all well and good in certain circumstances. The situation has become more complicated, however, as the concept of the 'third-party guarantee' has gained currency over the last decade. In this instance, the auction house does not assume the risk itself but passes it on to a favoured outside investor, who underwrites the sale in exchange for an undisclosed fee paid by the seller. The seller is not privy to the details of this arrangement. This is now the principal means by which the auctioneers now finance their guarantees.

In making this arrangement, however, the auction house has thereby pledged itself to two masters: its seller on one hand, but on the other an anonymous investor with a long record of doing business with the auction house whose interests may not overlap with those of its principal client. This is particularly the case when the guarantor may also be bidding on the seller's property (which they are allowed to do) all the while being paid a fee by the seller for a guarantee which they have known from the outset is redundant. To quote one such privileged bidder (in The Economist, 18th November 2011): "The playing field is not level, which is why I like doing third-party deals with Christie's. If I end up being the owner, I effectively get a discount even if it is not called that." This discount comes, of course, at the seller's expense.

The truth, of course, is that where once guarantees were a valuable tool in the auction houses' arsenals in the fight to win business from their rivals, they are now a welcome extra revenue

stream. In our view the most important comment on guarantees is a quote from Sotheby's then-CEO Bill Ruprecht in an investor statement of November 2014: 'Auction guarantees have been *meaningfully profitable* for the company' (our italics). Guarantees make money, for the auction house and for their chosen third party investors.

A seller also needs to consider the effect which the advertised presence of a guarantee may have upon the bidders upon whom a successful sale will ultimately depend. One of the attractions of auction has always been the chance it offers to confound expectations: no seller can be entirely immune to the hope that their lot may be the one that soars above its estimate and breaks records. The auction houses are quick to play to this, and their post-sale press releases are peppered with phrases like 'exceeded pre-sale expectations' and 'smashed existing world records'. When we advise sellers at auction, our key task is to ensure that the auction house makes our client's interests their key priority and employs every weapon in their very considerable armoury to bring this about.

A bidder's decision to abandon precedent and pay a record price for a work of art is not a purely rational one. There is alchemy involved. The best auctioneers play with human emotions: desire, competition, aspiration, passion. Buying at auction is a hot-blooded business. Sometimes it is the madness of a moment.

We should consider, therefore, the effect that a guarantee can have on the fragile and fleeting impulses upon which so much can depend. What does a bidder think when he or she sees in the catalogue one of the required symbols which indicates that one of the various permutations of back-room financial arrangement, to which he or she is not privy, is in play? Will the auction house staff give their best energies and priorities to those lots which they already know to be, effectively, sold?

It's interesting to analyse the results of a single auction in this light. In March of this year, the London auctions of Impressionist and Contemporary sales triumphantly vindicated that phrase 'exceeded pre-sale expectations'. Colin Gleadell, the Daily Telegraph's art market correspondent, wrote: 'The contemporary art sales in London last week passed in a wave of only briefly interrupted euphoria, totalling £286 million – a 53 per cent increase on last year...'.

One of the key sales of the week was Sotheby's Evening Sale of Contemporary Art. It realised proceeds of over £118,000,000, exceeding its total upper estimate (a very rare achievement across an entire sale). The top lot, a 1982 Gerhard Richter photo painting of an iceberg, realised £17.7 million (£15.6 million before Buyer's Premium) from an estimate of £8-12 million. Six new artist world records were set. It was a stunning sale.

Twelve of the 51 lots carried guarantee symbols printed alongside them in the catalogue (although a further 4 guarantees were announced by the auctioneer prior to the sale after third-party guarantors, sensing profits to be made, had piled in after the catalogue had gone to press). It's worth looking at how these 12 lots performed:

1 'failed to sell' (! or ? – we can't decide)

6 sold at or below the low estimate

2 more sold below mid-estimate

1 sold above its mid-estimate

2 exceeded their top estimates

In a sale which prompted one art dealer to comment 'this is a bulletproof market', over half of the guaranteed lots failed to launch.

There is no doubt, though, that guarantees are flourishing. In a recent newsletter ('Busting the Guarantees Myths', 25th April 2017, http://www.artagencypartners.com/need-to-know/adam/), Sotheby's Chief Operating Officer Adam Chinn notes that, of 166 lots offered by Sotheby's, Christie's and Phillips in the New York evening contemporary sales last November, 66 carried them in one form or another. Just as the auction houses would like us to, we are starting to take guarantees for granted.

As any of our forebears who enjoyed a cigarette could tell us, however, the fact that something is customary does not mean that it is beneficial, however highly it may be recommended at the time. Guarantees have not been tested in any meaningful way at law and they are not currently governed by any comprehensive regulatory structure. We believe that, as disputes begin to arise and we see them subjected to proper legal scrutiny, the next few years are likely to see a much greater clarification of the legal and commercial issues surrounding their sale and use. It is our view that guarantees are currently in something of a Wild West phase: many of the practices currently prevalent may well be living on borrowed time.

Of course, there are circumstances in which some kind of guarantee may be the right course of action for a seller. As a general rule, however, we approach any suggestion of a guarantee with extreme caution and consider with our clients in great detail the issues which such a recommendation by an auction house raises - most particularly that of whether auction is a suitable method of sale at all and whether a private sale may actually be a better option. We would suggest that any auction seller or their agent should do likewise and seek detailed advice.

Chattel Licenses – All change?

By Charles Cochrane

Chattel licenses became newsworthy in 2008 when *St Cecilia*, a painting by J.W. Waterhouse became the centre of a dispute over the level of rent that should be paid to a charity for its use. In this case the donor could have the painting back when it was not being exhibited provided a daily rate was paid. HMRC argued that the rate was not enough and eventually the matter settled out of court.

These licenses are also used for succession purposes and when offshore structures allow art to be used by UK-resident beneficiaries. It is worth noting that, away from the domestic scenario, art is regularly loaned to museums on short and long-term bases around the world and commercial galleries allow businesses to access their stock in order to decorate their premises to name but a few instances.

Changes to the value of the benefit of Art held Offshore but used in the UK

In December 2016 and without consultation (and despite subsequent protest from us, amongst others) a proposal was introduced, which is now to be enacted (relevant schedule of the Finance No.2 Bill 2017). By this legislation the official rate of interest is applied to the value of offshore held art used by a resident but non-domiciled beneficiary in the UK to deem an annual benefit. Assuming there were untaxed gains in the offshore structure taxable at a rate of 20%, the current official rate of interest of 2.5% would produce a benefit rate of 0.5%. Applied to art valued at £20,000,000 the benefit is therefore deemed to be £100,000 per annum, which will be paid until the tax is paid off. Costs can be deducted from this deemed benefit.

This makes the previous practice of negotiating a consideration redundant and the tax-take is likely to increase for many in the offshore environment. However, in this brave new world there is consolation for structures with no untaxed gains or income but before this turns to celebration for some, we understand that the deemed benefit will continue to be recorded annually and will be triggered if there is a future tax liability. Further strange results are likely due to the valuation methodology employed in the new legislation. There are other provisions to consider and we would be delighted to discuss them.

Onshore chattel licenses – the ground shakes!

HMRC announced at the 2016 annual Fiscal Forum meeting and again in a one-off meeting in June this year that the previously accepted benchmark rental level in the region of 1% of chattel value with costs in addition was no longer acceptable. They offered evidence of commercial licenses with much higher levels of rent – some at 10% and more!

A further meeting with HMRC and other practitioners in October this year will give us the opportunity to debate HMRC's evidence and its relevance. Clearly this raises many issues and anyone currently conducting a rent review or handling probate with a chattel license might seek immediate advice. In addition, please forward comments that you wish raised at the October meeting.

A further newsletter will set out the results of the October meeting.

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