



Co-Investing in Art: What Every Art Fund Manager Needs to Know

Art investment funds have long embraced the use of co-investments in artworks as a principal investment strategy. While the benefits of art co-investments clearly merit their use by art funds, art co-ownership arrangements do involve significant risks to the implementation of a fund's investment program that if not properly addressed can frustrate the fund manager's intentions regarding the ownership of, and anticipated benefits from, the co-owned artwork. As a result, art fund managers seeking to enter into art co-ownership arrangements should take the time to carefully formalize the mechanics of the co-ownership relationship with its co-investors prior to acquiring the subject artwork.

HOW ARE ART CO-OWNERSHIP ARRANGEMENTS CREATED?

As a general rule, art co-ownerships are created through the agreement (oral or written) of the co-owners or through the creation of a jointly owned special purpose vehicle ("SPV") that is formed to acquire one or more artworks. If one elects to form an SPV, the parties choose a form of legal entity (typically a limited liability company or a limited partnership) and draft the governing documents for the SPV to define the nature of the co-ownership arrangement. By contributing the co-owned artwork into the SPV, the owners are able to insulate the picture from claims of the creditors of one of the owners. Moreover, the formation of an art investment vehicle provides greater support for the deduction of the costs and expenses of acquiring, managing and disposing of the artwork. On the other hand, an SPV involves incurring substantial expenses in the formation and governance of the legal entity that a purely contractual co-ownership agreement avoids.

IMPORTANT MECHANICS OF THE CO-OWNERSHIP RELATIONSHIP.

In crafting a co-ownership arrangement, art fund managers should address, and with their fellow co-investors agree upon, the following decisions relating to the subject artwork:

Ownership Interests. The particular ownership interests of the respective co-owners in and to the jointly owned artworks should be clearly delineated either through an express understanding in the co-ownership agreement or by way of the underlying equity interests of each party in the SPV owning the subject artwork. Moreover, the parties should discuss consequences of any party failing to meet their ownership obligations.

Management. Of primary importance in a co-ownership structure is the manner in which an art fund manager must employ additional safeguards in connection with the acquisition, management



and disposition of its artworks. As a result, art fund managers should address with their co-investors how the following decisions will be made between them:

- **Possession.** An art fund manager should insist upon maintaining rights to possession of the subject artwork at all times. In doing so, the manager can alleviate the risks of having a co-owner sell the work without the fund's permission or having a co-investor's creditors seek to seize the work in satisfaction of outstanding indebtedness.
- **Museum Loans.** Art fund managers must insist that museum loan agreements require that only the fund manager has the right to give instructions or consents regarding the loaned art work, including in connection with requests by the borrowing institution to repair, clean, fumigate or frame/re-frame the work.
- **Leveraging.** An art fund manager must be sure that it can maintain compliance with any restrictions or prohibitions on leveraging artworks set forth in the governing documents of its art fund or in the loan documents of the art fund's underlying credit facilities.
- **Disposition.** Unlike individual collectors, art fund managers should insist upon controlling the actual sale process for the co-owned artwork in order to not only maximize the sale proceeds for the art fund's investors but also to avoid, or at a minimum disclose and clear with the fund's investors, any possible conflicts of interest inherent to the proposed avenue of sale for the work.
- **Interventions.** Art fund manager should be the one who determines the need for and character of any interventions on the co-owned artworks such as repairs, restorative work, cleaning, fumigation and/or framing/reframing.
- **Storage and Insurance.** Art fund managers must be sure that they comply with the various operational protocols communicated to their investors in their fund's underlying offering documents.

VOLUNTARY AND INVOLUNTARY TRANSFERS.

During the term of the co-ownership arrangements, foreseeable and unforeseeable events can occur that threaten the constancy of ownership of the underlying artwork in various circumstances:

Voluntary Transfers. As with any relationship, there exists within the co-ownership context the possibility that one of the parties may wish to end his involvement with the subject artwork and the other co-owners. There may have been a falling out between the co-owners, a change in the level of



risk one owner is willing to accept or a discrepancy between the owners as to the benefits they wish to derive from the investment in the artwork. Regardless of the motivation, it is not unreasonable for one of the co-owners to wish to sell his ownership interest in the artwork or the SPV, as applicable.

To address the adverse consequences of a voluntary transfer of an interest in the co-owned artwork or the SPV owning the same, the owners can and should utilize various techniques. The most commonly used restriction on voluntary transfers is the granting to the remaining co-owner(s) of a right of first refusal. Such right requires the selling party to notify the remaining owner(s) of an unrelated bona fide third party offer for the selling party's ownership interest in the artwork or the SPV, as the case may be. Such remaining owner(s) are then afforded the opportunity to match the third party offer.

The use of a tag-along right is also available to protect the interests of the co-owners in the event of a desired transfer by one of the owners and often arises in the context of an unexercised right of first refusal. A tag-along right grants the nonselling co-owner(s) the right to have their interests in the artwork or SPV included pro rata in accordance with their ownership interests in any potential sale of interests by a selling owner. When combined with a right of first refusal, the remaining owner(s) are in essence granted two options, the right to acquire the selling owner's interests or the right to reduce their own interests.

Involuntary Transfers. Even when the relationship of the co-owners is intact and the parties maintain the same vision as to the direction of the art investment, certain events can and do arise that in essence will end an owner's ownership of a portion of the artwork or SPV, as the case may be. In such instances, death, bankruptcy or divorce, it is important to provide protections to the remaining co-owner(s) so as to ensure the constancy of ownership over the subject artwork or SPV as well as provide ample liquidity for the interests of the departing owner.

Upon the death of one of the co-owners, it is important to provide for an immediate required purchase by the remaining co-owner(s) of the decedent's interests. While the owners can instead opt for a call right by the remaining co-owner(s), the practical effect of such option is to deny the estate of the decedent with a guaranteed outlet for the disposition of its interests, forcing it to seek out third party purchasers.

The bankruptcy and/or insolvency of an owner can also lead to the unwanted inclusion of his or her creditors as co-owners of the artwork or SPV. Such creditors can, and often, do have different objectives for the direction of co-investment, most notably the recapture of monies owed to them by the bankrupt owner. Accordingly, the remaining co-owner(s) should be given the right, but not the obligation, to purchase the shares of the bankrupt owner.



Just as in the case of the death of an owner, the termination of a marriage of an owner can have similar consequences upon the ownership of the co-owned artwork or SPV. In many jurisdictions, the ownership interests in and to the artwork or SPV are deemed to be marital assets and can be divided or fully transferred to a non-participating spouse as part of a divorce settlement. To answer this problem, the co-ownership agreement or the governing documents of the SPV should grant the remaining co-owner(s) the right, but not the obligation, to purchase the interests of the divorcing co-owner upon the occurrence of a divorce or other marriage dissolution event.

CONCLUSION

Art funds have and will continue to utilize co-investments as one of their primary investment strategies. In pursuing such co-investments, an art fund manager must remember both its fiduciary obligations to its investors as well as the terms of its fund's governing documentation when crafting such a relationship. By focusing the attention of the other co-owners on the mechanics of the co-ownership arrangement, an art fund manager can help the participants agree on the particular attributes of their relationship and in doing so, prevent both foreseeable and unforeseeable events from hampering their intentions regarding the ownership of, and anticipated benefits from, the co-owned artwork.

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