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The Art Market Adjusts: Protecting consigned artworks from creditors

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In financially uncertain times, both artists and collectors who have works on consignment should take the necessary steps to protect their works of art from seizure by a consignee's creditors. We have found that many consignors are unaware that, in certain circumstances, they can lose the rights to their artwork to a secured creditor of a consignee gallery or dealer. Fortunately, collectors and artists can reduce their risk with a Uniform Commercial Code (UCC) filing. Without this filing, consignors expose their works of art to creditor claims in a bankruptcy situation.

In this conversation, my colleagues, Dean Nicyper and Kimberly Almazan, discuss how collectors and artists can utilize UCC filings to protect themselves and their consigned works of art.

Diana Wierbicki
Global Head of Art Law

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Kim: You and I have both handled a number of cases on behalf of collectors in which a gallery is struck by financial hardship. People are always surprised to hear that, without putting protections in place, a collector who consigns a work of art to a gallery for sale might lose that work of art to the gallery's secured creditors in a bankruptcy situation. Can you explain why this is the case?

Dean: Sure. Let's say you are a collector and you consign your painting to a gallery for sale. The gallery owner tells you he thinks he can find a buyer within 6 months and that he will not sell it for less than $500,000. You sign a consignment agreement with the gallery and walk away thinking that you have protected your rights. Three months later, you realize that the gallery has been having financial problems and you go to the gallery to retrieve your painting. But your painting is gone. It turns out, the gallery had a creditor (usually a bank or other lending institution) and that creditor now claims that your rights to your painting are subordinate to its right to foreclose on and sell the painting to be reimbursed for its unpaid loan. But you are the owner of that painting and you should get it back, right? Not necessarily.

Under a set of laws known as the Uniform Commercial Code ("UCC") which governs commercial transactions, including consignments, inventory covered by a lender's security agreement includes not only art owned by the gallery, but also art that is consigned to the gallery. So, under the UCC, if the gallery becomes insolvent or bankrupt, the bank or other creditor can take all collateral including consigned art until it recovers the amount it loaned.

Kim: This sounds scary for collectors, but there is a fairly easy way for collectors to protect themselves. Can you explain what a UCC-1 Financing Statement is, and what effect it has in these types of situations?

Dean: Collectors who consign a work of art to a gallery can file a document, known as a UCC-1 Financing Statement, with the Secretary of State's office in the state in which entity owning the gallery was formed. This UCC-1 Financing Statement should be filed prior to delivery of the consigned work(s) to the gallery or art merchant. Filling out the UCC-1 Financing Statement is fairly simple; one must list the consignor (the collector), the consignee (the gallery), and provide a general description of the collateral. The collector then submits this form to the Secretary of State and pays a small filing fee, usually between $20 and $50, depending on the state.

The filing of this document provides notice to all of the gallery's creditors and potential purchasers that the collector holds an interest in the work of art. The rationale is that, by filing the UCC-1 Financing Statement, encumbrancers are able to ascertain the existence of security interests in property by checking a centralized record system. In other words, the UCC system, like title recordation systems for real property, is based on providing constructive notice through recordation.

Kim: This situation can be potentially complicated if the gallery's creditor or bank filed a UCC-1 Financing Statement that covers all of the inventory in the gallery before the collector files his or her UCC-1 Financing Statement covering his or her particular work of art. Is there anything collectors can do to protect themselves in this situation?

Dean: If, before the collector delivers the consigned art, he or she informs the gallery's secured creditor(s) in a written notification that he or she will be consigning art, the collector does not need to get the creditor's approval for the art to be outside of the bank's collateral. In order to do this, the collector will need to perform a UCC lien search in the state in which the entity owning the gallery was formed to find out the identities of the gallery's other creditors. The collector must then send the written notification to all of the gallery's secured creditors that filed UCC-1s.

If the collector fails to notify the gallery's creditor(s) in writing prior to delivery of the consigned work, and the collector files a UCC-1 Financing Statement subsequent to the creditor's filing its UCC-1 Financing Statement, the collector can contact the creditor and seek an express, written exception to the creditor's security interest.

Kim: Artists, unlike collectors, have special protections in these situations. Certain states in the country have statutes specifying that consignments by artists are not subject to claims by a gallery's creditors. You had a role in crafting provisions of this type of statute in New York. Can you explain how these statutes work?

Dean: That's right. New York has had a carve-out in place for decades — Section 12.01 of the Arts and Cultural Affairs Law — establishing that artist-consigned works of art are trust property held by the gallery for the exclusive benefit of the artists, and establishing that proceeds from the sale of those artists' consigned works are trust funds held for the exclusive benefit of artists. In 2012, after the collapse of the Salander O'Reilly Gallery, in which many of these issues unfortunately played out for collectors in the gallery's bankruptcy, I was involved in prompting the New York Legislature to enhance this statute to, among other things, allow artists to enforce certain rights directly against galleries. Similarly, in California, Civil Code Section 1738.5 states that where an artist delivers a work of art that he or she created to an art dealer/gallery for the purpose of sale or exhibition, that work of art shall not be subject to a claim by a creditor of the art dealer/gallery. As a result, in certain states, artists consigning their own works of art to galleries for sale will not have to file a UCC-1 Financing Statement as collectors do.

Thus, while financially uncertain times can certainly create worry, both artists and collectors have the ability to protect themselves and their works of art from seizure by an unknown creditor.

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