AUCTION GUARANTEES: ALL ANIMALS ARE EQUAL, BUT SOME ARE MORE EQUAL THAN OTHERS

Auction guarantees are back in full swing. The current guarantee figures are as follows:

- $2.1 USD billion worth of art for sale at Sotheby’s and its archrival where $1 billion are in-house guaranteed.
- $75.3 USD million to be sold by Phillips, where $42.9 million worth is in-house guaranteed.
- 267 guaranteed lots in November sales (record).

As Kristine Korber, a senior analyst with Barrington Research would point out, we have “never seen this level of guarantees for one auction.” It turns out guarantees are back mostly because they are a better deal to the consignor. The auction houses are in the business of getting consignments and that is what they do best, no doubt about it. It is also where the competition is most fierce. Never before had guarantees been a more desirable and widely-used tool to lure in sellers that are well aware of the

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potential “catastrophic” consequences of a “bought-in” scenario. This is, when the work is not sold at auction (statistically there is a 20% chance) -including the possibility that the piece may not recover its present value in as long as six or seven years-.

But let me back-track. I remember back in the days when a “B.I.” meant opportunity. Often savvy dealers and tested collectors would let their truly desired lots pass at auction, in order to buy them for the reserve or less. Often times, I literally ran to the auctioneer at the end of the sale to be the first one to make an offer (usually around what I estimated to be the reserve price) and the auction house would negotiate and reduce the premium, or talk back to the consignor. They would come back within a day or two with an answer, sometimes that same evening, if they where doing their job well. Unless you knew every sale of the last twenty or thirty years by heart (which I did) and collected all catalogues with determination, no one else would remember a “B.I.” a year or two later. All you had to do was put the painting to “rest” a little and bring it back “fresh”. What really mattered was the artistic merit of the painting, not if the auctioneer was not on his best day or simply passed the lot too fast. Today much has changed, and now a “B.I.” is a curse. Art search engines available on the Internet have replaced the eye-memory muscle. You do not need to go to the sales or collect the catalogues. I miss those days, when a professional and dedicated approach really counted for something.

Let’s review some basic mechanics of auction guarantees. With a minimum term of three months in advance, the seller will agree to place the artwork at an auction house to be put on the block. The costs that such instrument implies for the client who commissions the work for sale are: (i) paying the guarantor a fee for the issuance of the guarantee and (ii) sharing considerable percentages with the guarantor -as much as 30% to 50% of any profit gained-. The profit on the transaction (called “overage”) is calculated as the difference between the “reserve price” and the “hammer price”. While auction guarantees are quite expensive, the artwork’s owner does enjoy, in exchange, the absolute tranquility of avoiding a B.I., and the security of at least receiving the agreed reserve amount. When the painting is failing to attract bidders to reach the guaranteed amount, the auctioneer might bid against the “chandelier” (on behalf of the seller) or bid for the absentee guarantor “on my book”.

The guarantee business gets murky when the auction houses themselves guarantee the work. The use of in-house guarantees has gone in and out of fashion depending on the strength of the art market. They “exploded” at the end of the twentieth century but were initially offered as early as the 1950s,
when Sotheby’s chairman Peter Wilson guaranteed £35,000 for Nicolas Poussini’s The Adoration of the Shepards to its owner in 1956. Despite the negative result of this particular sale (since it only achieved a selling price of £29,000) the “publicity” in favor of auction guarantees that was then generated compensated for any downside.4

When the art market boomed from 2004 to 2007, so did guarantees, and auction houses competed for the most valuable works by offering their owners higher guaranteed reserve prices. This can be seen in the enormous amounts guaranteed in 2006 and 2007, for example, by Sotheby’s. Such auction house issued guarantees in 2006 adding $131 USD million, which dramatically rose in 2007 to $902 USD million.5 The auction houses’ participation in the guarantee market suffered a serious downturn (as did pretty much every single financial product) in fall 2008. In May of that year, auctions in New York had been quite fruitful, with sales over $1.5 USD billion.6 But over-optimistic promises had been made to sellers prior to the November sessions, and the guarantees that had already been issued had locked down prices that became totally unrealistic after the financial meltdown of Lehman Brothers. “For example, Sotheby's reported that it had lost $28.2 USD million from guarantees at its contemporary art auctions in November 2008. That brought its total losses to about $52 USD million this fall, all from guarantees.”7 This avoidable, but mostly unforeseeable misstep, led to auction guarantees not being issued anymore, albeit temporarily.

When auction guarantees were reinstated, there was a significant reformation: third party guarantors. And now, in the November 2015 auction, large auction houses are again taking a much

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larger share of the auction guarantee market *vis a vis* third party financiers. It might therefore be a good moment to go into the details of the differences that exist between “in-house guarantees”, i.e. those issued by the same auction houses through which artworks are being sold, and “third party guarantees”, i.e. those issued by persons or entities other than the auction houses.

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<th>“In-house” Auction Guarantees</th>
<th>“Third-party” Auction Guarantees</th>
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<tr>
<td>Access to the Auction Guarantee Market</td>
<td>Auction houses control access by third-party consignors to the auction guarantee market given that they own the sales channel. While auction houses usually welcome knowledgeable third-party guarantors with sufficient financial strength because they serve to reduce the risk of taking all guaranteed lots on their own, they reserve the right to an agreement with such third parties.⁸</td>
<td>Third-party guarantors must negotiate an agreement with the auction houses whereby the details of their role as such are specified, including potential overage splits with the auction house, financing fees charged to the consignor, and guaranteed lot selection process. These agreements usually include a strict confidentiality clause protecting the “economics” behind the deal.</td>
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<td>Price Inflation⁹</td>
<td>The auctioneer is allowed to bid on the artwork on behalf of the seller, which may lead to price inflation, as the guarantor (i.e. the auction house) wishes the guaranteed artwork to sell for the highest amount so that its overage will also be as high as possible. The backdrop for being willing to assume such a risk might be, for example, the existence of a private seller that has already shown interest to repurchase the work from the house.¹⁰</td>
<td>The guarantor is allowed to bid on the artwork—and does so when he actually likes the work on the block—as far as he does not incur in “puffing”. Third-party guarantors normally do not intend to buy the piece nor pay the commissions associated with a high sales price. Their interests are mostly aligned with those of the consignor. Third party guarantors usually have much less placement capacity than auction houses.</td>
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<td>Buyer’s Premium and other Fees</td>
<td>Should an auction house “win” the bid (not sell the lot) it will naturally not pay the buyer’s premium to itself. It will pay the guaranteed price as agreed to the consignor. Financing fees are still charged to the consignor in this scenario.</td>
<td>Should a third party guarantor &quot;win&quot; the bid on a guaranteed lot, it will be obligated to pay the buyer’s premium (perhaps with a discount) to the auction house, in addition to the hammer price. Financing fees are still charged to the consignor in this scenario.</td>
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⁸ Sotheby’s disclosed in April 2015 that $279 Million USD had been issued in guarantees, of which only $65 Million (i.e. 23%) were backed by third parties. See: http://www.artmarketmonitor.com/2015/01/08/do-auction-house-guarantees-drive-up-prices/

⁹ “They act like steroids” Todd Levin, director of New York-based Levin Art Group. (Inflating artificially the prices instead of by their artistic merits).

¹⁰ “While guarantees appeal to sellers, they can alienate buyers. A certain kind of collector doesn’t even buy at auction anymore,” said Wendy Cromwell, a New York-based art adviser.
### Auction Process

The auction house controls the session, sets the reserve price, the amount of the initial bid, as well as the low and high estimates for the piece, and may use measures -however legally questionable- such as “chandelier bidding” to increase the amount of the bids.\(^{11}\)

Third-party guarantors have the same instruments as regular bidders during the auction session. As opposed to other bidders however, they do know the reserve price of the artwork.\(^{12}\)

### “Flipping”

It is argued that auction houses may stand less to lose than do third-party guarantors by acquiring the auctioned piece and then trying to sell it privately. Although this is not always true, this belief is based on the large list of potential buyers they already have as a consequence of their regular operations.\(^{13}\)

The incentive for third-party guarantors is usually not “flipping” the artwork (i.e. acquiring it with the express intention of reselling or having committed it already to a potential buyer) but rather, charging an attractive overage. As mentioned before, they are expected to have less possibility to place an artwork than do auction houses.

Auctions are public sales and their catalogs mark guaranteed works of art with a special notice (not always when the guarantor is the auction house itself though) but that may not suffice. In addition, at the beginning of a sale, auctioneers announce that guarantors may be bidding. This too may not be enough for transparency’s sake. Outside bidders lack confidential information regarding the reserve

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\(^{11}\) Auction houses refer to chandelier bids as “bids made on behalf of the consignor.” Their existence is stated in signs, in the sales catalogues and sometimes announced by the auctioneer. However, no one identifies these bids as not representing an actual bidder during a sale, and real bidders may be led to believe there is real competition for a given lot, prompting them to spend more than they might have otherwise, according to auction observers. Information taken from "Chandelier Bid Definition." *Investopedia*. 22 May 2014. Web. 5 Nov. 2015. http://www.investopedia.com/terms/c/chandelier-bid.asp-0

\(^{12}\) It is argued that, if all bidders knew the reserve price, while apparently more fair to everyone in the auction room, auctions would not entirely serve the purpose of achieving sales prices that are attractive to the consignors, as increments in bids would be minimum. “You have to wonder, though. As silly as the chandelier debate is, why not start at the reserve?” declares Marion Maneker. The editor in chief of Art Market Monitor goes further on: “Too many sales these days stall out as dealers hope to see something bought in and then engage in an after-sale negotiation. That seems far more unfair than the signaling bids the auctioneer makes. Lately, bidding has begin to take off when the person with the gavel says, "I can sell it" and alerts buyers that it is now or never. Wouldn’t starting at the reserve unleash the same animals spirits?” Maneker, Marion, "Christie’s Reveals New Weapon: Guarantee Partners" *The Art Newspaper*, Web. 28 Oct. 2015. http://www.artmarketmonitor.com/2015/07/08/the-art-newspaper-reveals-christies-new-weapon-guarantee-partners/

price of the work of art in question, as well as the guarantor’s identity. As guarantor identities are not publicly disclosed, other bidders do not know whom they are bidding against at auction. Guarantors would seem to have an unseen advantage in their knowledge of the reserve price and can bid to raise the hammer price. In fact, guarantors may benefit as bidders even when they end up having to buy the auctioned artwork.14

The problem, some dealers, collectors and art advisers say, is that the neutrality of an auction is lost when underwriters can bid on a work they have guaranteed. Critics argue that the guarantors have an undisclosed interest in the outcome and an unseen advantage over other bidders because a buyer who actually wants the work might wind up competing against someone who only wants to bid up the price. “Secrecy keeps you from knowing you’re paying too much,” says Rachel Campbell, an economics professor at the University of Maastricht.15

Whatever the ethics of the auction guarantee system, it has certainly been a major factor in wooing consignors of major works, has almost certainly let to higher prices for art and has been an important factor in driving the market, at the top end, towards auction. But, in the smoke-and-mirrors world of the auction salesroom, it might behoove the art industry to move towards more transparency on consigning valuable works of art without withholding important information from prospective buyers.

By Javier Lumbreras, with the collaboration of Federico León de la Vega and Giovana Edid

14 “The concern with third-party guarantees, which apply most often to the most valuable works sold at auction, is that when a third party has assurance it can buy a work of art at a reserve price and no one else in the room knows that, the third-party guarantor can bid indiscriminately to drive the price up so high that no one else will be able to buy the work save the guarantor, who often receives a discount on hammer price as an incentive to enter into the guarantee relationship with the auction house. The guarantor may also receive a financing fee from the auction house whether or not he or she is the winning bidder. This is a form of market distortion and there is a real concern about the costs passed on to buyers at auction with the respect to third-party guarantee arrangements and the significant buyer’s premium every buyer must pay on top of the purchase price.” Picinati, Adriano Et al. Art & Finance Report 2014, Ed. Deloitte and Art Tactic, 2014. p.122


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