ARM'S LENGTH DEALING IN THE ART MARKET

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One of the common criticisms made against art as a formal investment asset class, mostly by mainstream business and financial consultants, is that the art market seems to be more prone to conflicts of interest than others. A "conflict of interest" is a "a situation where a professional, or a corporation, has a vested interest which may make them an unreliable source. The interest could be money, status, knowledge or reputation for example. When such a situation arises, the party is usually asked to remove themselves, and it is often legally required of them".[1] According to *Deloitte's Art Tactic's Art & Finance Report 2014*, the "lack of transparency and difficulties in sourcing and finding the right art-related expertise" are amongst the art industry's main obstacles, together with the lack of regulation. Artemundi has written before on how the lack of regulation is not necessarily negative in all aspects nor is it an obstacle to investing successfully in the current art market.[2] We have also shared our experiences in sourcing experts, and more importantly, on how to work with them in practice to achieve consensus and the validation expected from their involvement when examining a particular artwork.[3] This article however, focuses on the perceived difficulty in achieving a transparent and fair transaction when dealing in art.

In most, if not all industries, the seller is considerably more knowledgeable about the product than the buyer. This is true in both regulated and unregulated sectors. Traditional investors seek their stockbroker's advice, as do potential homeowners from professional realtors. Classic car collectors also seek guidance from vintage-specialized mechanics. It is true that the stock market and the real estate market are more regulated than the classic car market in the sense that, in the former, intermediaries must be licensed and there is a wide array of rules calling for full disclosure on the investments. And in the latter, there are little -if any- governmental regulations or authorities overseeing the specific trade (yet). While regulations are advisable to protect the inexperienced, misinformed or naïve investor in any asset class, they are not entirely sufficient, as we have seen in the past.[4] The numerous cases of insider trading that still are discovered in the stock market suffice to make this point. Inversely, the absence of

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[1] An example of a conflict of interest would be a board member voting on the induction of lower premiums for companies with fleet vehicles when he is the owner of a tow truck company outside of the corporation. In relation to law, representation by a party with a vested interest in the outcome of the trial would be considered conflict of interest, and the representation would not be allowed. Recovered from: "Conflict Of Interest Definition." *Investopedia*. 14 Apr. 2009. Web. 6 Aug. 2015. http://www.investopedia.com/terms/c/conflict-of-interest.asp#ixzz3hn7cg5NX.

[2] Artemundi agrees with Deloitte's assertion that "*a certain level of regulation in the art market would not only be helpful for the Art & Finance industry, but also for the market as a whole*." However, it is the right degree of regulation which is the central theme and should be the focus of the discussion. Please see Picinati, Adriano Et al. *Art & Finance Report 2014,* Ed. Deloitte and Art Tactic, 2014. p 22.

[3] Please refer to Evoli, Paloma. "Unregulated Art Maket." *Artemundi Global Fund.* Artemundi Group. Web. 6 Aug. 2015. http://artemundiglobalfund.com/wp-content/uploads/2015/03/Unregulated-Market-Finance.pdf and Edid, Giovana, and Federico León De La Vega. "Sourcing the Right Experts." *Artemundi Global Fund.* Artemundi Group. Web. 6 Aug. 2015. http://artemundiglobalfund.com/wp-content/uploads/2012/08/SOURCING-THE-RIGHT-EXPERTS.pdf .

[4] Please refer to "Art in Transit: The Unregulated Market of Art." *Artemundi Global Fund.* Artemundi Group. Web. 6 Aug. 2015. http://artemundiglobalfund.com/wp-content/uploads/2015/03/Unregulated-Market-Art.pdf .

any such regulations relating uniquely to the art market could hardly be used to support the argument that art transactions, in general, lack transparency.

So, if the explanation does not lie in the existence of regulations (or the absence thereof), which factors play into the possibility of achieving a fair deal in the art market? Dealing "*at arm's length*" is defined as "beyond the reach of personal influence or control. Parties are said to deal "at arm's length" when each stands upon the strict letter of his rights, and conducts the business in a formal manner, without trusting to the other's fairness or integrity, and without being subject to the other's control or overmastering influence."[5] Certainly, there is a question of ethical conduct engrained in acting with fairness and integrity. But beyond ethics, the answer really lies in a series of *de facto* variables. It is not that the lack of regulation in the art market leads to conflicts of interest more than in others (or that the existence of regulation in other industries eradicates or even considerably reduces conflicts of interest for that matter), but rather, perhaps the issue is that there is greater power polarity between sellers and buyers in the art market than in other markets. When it comes down to the actual transaction, what is needed to avoid a conflict of interest and achieve a true *arm's-length* deal? These variables may include equal knowledge and/or power, similar access to information, equal or similar prestige, validation in the market, and as the story below shows, even keeping cool-minded.

One of the most recent scandals in the art world touching on this subject involves Kevin Zuchowski-Morrison, Rise Gallery's owner in south London, who acquired Opus Art from Donald Smith and Emma Poole in April for "a six-figure sum." Zuchowski-Morrison declared: "Don approached me on my wedding day last year telling me that he and Emma wanted to retire to France and whether I was interested in buying their gallery". He soon discovered that Opus Art had amassed a £15,000 credit card debt, plus a £15,000 overdraft, and also began receiving numerous complaints from people demanding money from artworks they claimed Smith and Poole had sold for them. "The invoice demands were flowing in—totaling at least half a million pounds ($781,000)—from a lot of irate people. I feel like a naive fool now." Zuchowski-Morrison said.[6] In this case, the friendship with Smith blinded Zuchowski-Morrison's objectivity, not to mention that the transaction was made during Zuchowski-Morrison's wedding day. Conscious of the Opus Art Gallery's problems, Smith most probably took advantage of the moment, eluding an *arm's-length* transaction.

Donald Smith at Opus Art Gallery

An *arm's-length* transaction is defined as "a transaction in which the buyers and sellers of a product act independently and have no relationship to each other. The concept of an *arm's-length* transaction is to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other party."[7] Traditionally in the art world, an average buyer

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[5] Hirby, James. "What is AT ARM'S LENGTH?" *The Law Dictionary*. Web. 6 Aug. 2015. http://thelawdictionary.org/at-arms-length/

[6] For further reading please refer to: Muñoz-Alonso, Lorena. "T Dealers Donald Smith and Emma Poole Flee To France After Being Investigated for Theft and Fraud." Art News. 3 Aug. 2015. Web. 5 Aug. 2015. https://news.artnet.com/art-world/british-art-dealers-investigated-theft-fraud-donald-smith-emma-poole-321854

[7] "The concept of an arm's length transaction commonly comes into play in the real estate market. When determining the fair market value of a piece of property, the price for the property must be obtained through a potential buyer and seller operating through an arm's length transaction, otherwise, the agreed-upon price will likely differ from the actual fair market value of the property. Recovered from: "Arm's Length Transaction."

depends on the dealer, auction house or gallery to determine whether he's getting a good deal or not. This naturally places the intermediary in a situation where he is subject to a conflict of interest and the deal would run the risk of not being negotiated and closed at *arm's-length*. The gap between seller and buyer in the art world may be considerable and is likely greater than the difference which exists between the investor and stockbroker, or the buyer of a home and his realtor. This is true to the degree that professional buy-side advisors have recently come in to level the field in the art industry, where not so long ago, only the sellers had any "true expertise." The role of family offices and other entities such as art investment funds has come to increase the likeliness of art collectors entering into *arm's-length* transactions with the larger players of the art market.[8]

To illustrate the above, consider galleries that "appraise" the art from the artists that they themselves represent. This not only entails a flagrant conflict of interest, but also, the valuations that they arrive at may give buyers delusionary ideas about the liquid value of the works that are purchased. For example, the Russian art dealer Anatoly Bekkerman and his New York gallery, ABA Gallery, were the target of a lawsuit by a Luxembourg-based company, which claimed that the dealer sold fake and overpriced art. During 2007 and 2008, the buyer purchased 18 paintings from the ABA Gallery for a total of $9.8 million USD. The complaint alleged that, even though each of the artworks had their own certificate of authenticity, they had substantially lower value and were sold through a "multi-pronged and multi-faceted intensive campaign to defraud." Although they are not named in the complaint, two members of Sotheby's Russian Art Department were also accused of helping Bekkerman carry out the fraud, making this a clear example of conspiracy within the transaction.[9] In this case, an *arm's-length* deal might have been reached by involving independent appraisers, who probably would have warned the buyer. Especially when an artist's market is created, constructed, maintained and manipulated entirely in-house, it is highly recommended to use third party experts to value art before the purchase.

Anatoly Bekkerman (on the right)
at ABA Gallery

Today there is undoubtedly, and increasingly, more access to information on art and investing in art than before. The asset class has made important advances towards democratization. The more people invest in art, and the more "mainstream" investing in art becomes, the smaller the gap between sellers and buyers of art will be. However, for the time being, and as the market evolves (and its volumes justify government oversight) *arm's-length* transactions may be more easily achieved by collectors investing through art funds or other institutional vehicles with the required financial weight and curatorial expertise. In the current art market, art funds may have a greater possibility of attaining fair transactions than individual collectors. The result of an *arm's-length* transaction is palpable in the following respects, for example: it is legitimate, it is closed at fair market value, and it does not favor one party over the other. The *arm's-length* quality of the deals is further improved if, as happens in the case of Artemundi, purchases are performed: (i) with the collaboration of independent appraisers, (ii) applying detailed examination and valuation protocols, (iii) dividing the transactional costs among the

Investopedia. 14 Apr. 2009. Web. 6 Aug. 2015. http://www.investopedia.com/terms/c/conflict-of-interest.asp#ixzz3hn7cg5NX

[8] Please see Picinati, Adriano Et al. *Art & Finance Report 2014,* Ed. Deloitte and Art Tactic, 2014. p 22.

[9] Zeveloff, Julie. "New York Art Gallery Sued For Selling $6.5 Million In Phony And Overvalued Russian Art." Business Insider. Business Insider, Inc, 5 July 2011. Web. 7 Aug. 2015. http://www.businessinsider.com/art-gallery-sued-over-phony-russian-art-2011-7 .

investor pool; and (iv) between the fund and private collectors, as opposed to traditional sale-side agents.

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