UPSIDES AND DOWNSIDES

Protecting a sale with an art market guarantee or 'irrevocable bid' can mitigate the risk involved in art handling, writes **Simon Wills**

Selling artwork at auction has traditionally come with some inherent risk. Despite the efforts made by specialists to offer each piece of property at the correct estimate for its market and engage as many bidders as possible, a certain number of lots in almost every auction inevitably go unsold.

This has consequences beyond the lack of income through the sale: once something has passed at auction, it is often considered 'burned' and may be more difficult to sell in the near future, at least without a significant discount.

Enter the art market guarantee: offered to selected sellers, this type of guarantee (also known as an irrevocable bid) provides a minimum price to the consignor, regardless of the outcome of the auction. In exchange for taking on this risk, the auction house, or more commonly a third-party guarantor, will receive a portion of the 'upside' (any amount paid by the buyer above the guaranteed price).

As such, an irrevocable bid offers 'downside' protection for risk-averse sellers and a potentially significant financing fee for the guarantor should the artwork outperform its guaranteed price. In 2018, guarantee deals hit an all-time high, covering roughly USD3.47 billion in auction sales worldwide.[1]

THE RISE OF THIRD-PARTY GUARANTORS

Third-party guarantors were often collectors and art market investors, and because irrevocable bids meant that the guarantors would receive a portion of the upside, some claimed this created a potential for market distortion. The issue was that the irrevocable bid scenario amounted to a discount not offered to other bidders and, therefore, if there were no competing bids and the third-party guarantor won the lot, the reported purchase price ('hammer price' plus buyer's premium) would not amount to the true market value.

This caused enough concern in the marketplace that, in 2016, New York City's Department of Consumer Affairs mandated that auction houses subtract any financing fees paid to third-party guarantors from the total price reported to the public.[2] Despite additional scrutiny, these deals continue to attract third-party participants, enticed by the prospect of an easy windfall speculating on the art market. Before taking this gamble, however, potential guarantors, as well as sellers, should consider the risks.

RISKS

Auction houses know their market, and will keep any deal that they feel is a sure thing for themselves and the company. Third-party guarantors should not be looking at these deals as an acquisition opportunity with upside potential; rather, guarantees are a speculative gamble in which the underlying asset is secondary.

Sellers, too, need to be astute when consigning under an irrevocable bid. For some, downside protection is a major concern and, unlike in a private sale scenario, there is no limit on how high the bidding can go, so they are willing to trade off a portion of the upside. Again, however, they should be mindful that the auction houses know the market and will resist putting up an aggressive guarantee.

Further, the upside split, while typically in the range of 80:20 in favour of the seller, can be as much as 50:50. Consider that when you look at the result of the sale of Leonardo da Vinci's *Salvator Mundi*, which reportedly carried a guarantee of around USD100 million. An astronomical sum, but the work hammered at USD400 million (USD450 million with premium), meaning that the seller had to give back a portion of USD300 million of upside.

'Guarantees are a gamble in which the underlying asset is secondary'

Finally, sellers should be aware that, with an in-house irrevocable bid, the auction house has a strong incentive to stand behind and promote its own works in order to cover the guarantee and protect itself from a loss. Conversely, if a third party is the guarantor, the auction house might feel less pressure to 'sell' the work (as it is already effectively pre-sold to the guarantor), since its own money is not on the line.

CONCLUSION

Art market guarantees continue to be popular and offer a unique opportunity for both potential sellers and guarantors. All parties must, however, consider the above factors carefully; the trade-off to avoiding the risky proposition of an auction sale could be costly.

1 *The Art Newspaper* 'Guarantees: The next big art market scandal?', 12 November 2018 **2** *Bloomberg*, 'Auction Houses Told to Improve Transparency in Reporting Prices', 17 October 2016

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