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The Art Investment Contract: Application of Securities Law to Art Purchases

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THE ART INVESTMENT CONTRACT:
APPLICATION OF SECURITIES LAW TO
ART PURCHASES

I. Introduction

The best capital investment is not South African
gold or Canadian wheat or Bolivian tin, but art.¹

The common regard for art as a luxury acquisition exclusively
within the province of the wealthy has undergone dramatic change
in recent years to a general respect for art as an accessible invest-
ment property.² Major corporations improve their public image by
funding the arts and swell their assets by acquiring art in various
media.³ Mutual fund consortia have been set up to purchase art.⁴
Investment advisors increasingly encourage their clients to
purchase art as a hedge against inflation.⁵

Yet art works have little intrinsic value.⁶ The value of an acqui-
sition is peculiarly dependent upon transient and unpredictable

1. L. DuBoff, DESKBOOK OF ART LAW at 364 (1977) [hereinafter cited as DESKBOOK]
   (quoting Maddocks, Picasso and the Midas Touch, Christian Science Monitor, Dec. 22,
   1975, at 26, col. 3). Art properties compare demonstrably well with traditional investment
   vehicles such as stock. Art works have shown an overall appreciation of 1800% over the last
   twenty years, compared with 400% for stock. DESKBOOK, supra, at 361-62.

2. Prints from the Picasso 347 Series were “traded over the telephone from dealer to
dealer like coffee futures, for as much as $1 million.” Saltzman, Lively Market in Prints,
ARTNEWS, Sept. 1979, at 78. Museum and auction attendance has risen markedly as the
public is drawn by media coverage of museum treasures of inestimable value and sensational
bidding at major houses. See TIME, Dec. 31, 1979, at 46-55. The exploitation of art as an
investment property has provoked writers to harsh criticism, see, e.g., Hughes, Confusing
Art with Bullion, TIME, Dec. 31, 1979 at 55-56, and antagonized artists who resent seeing
their work “bought and sold like so much expensive, inedible fish, to be hidden away in
locked vaults.” N.Y. Times, Nov. 25, 1979, at B6, col. 3.

Corporate contributions to the arts have already reached $250 million annually. Id. at 43.
The art holdings of Chase Manhattan Bank have been estimated at more than $5 million.
See Sloane, Collecting at the Chase: Fine Art Stands for Good Business, ARTNEWS, May,
1979, at 48.

4. DESKBOOK, supra note 1, at 380-81.
5. Id. at 361.

6. See R. Duffy, REPRESENTING ARTISTS, DEALERS AND COLLECTORS at 2 (1977) (herein-
after cited as Duffy). Each work is complete in itself; whatever merit it possesses must be
judged, uniquely, by reference only to itself. The purchaser of an art work acquires an inter-
est in the artist’s continued market success; one purchasing the work of a living artist be-
fits from the artist’s continuing production.
vagaries of taste. Although vast sums are traded annually, there is no central exchange for art and no readily monitored daily price quotations to guide the unsophisticated purchaser in determining the current and potential value of art as an investment prospect.

To minimize the investment risk, the advice of an art expert may be necessary to aid in the final selection, but securing such independent advice may be beyond the means of a growing number of purchasers. These investors must frequently rely upon persons whose interests may not coincide with their own.

Art transactions are in substance investment contracts. Accordingly, the art investor could benefit from the same preventive and remedial regulations imposed upon conventional investment transactions. This Comment will first describe and analyze the five principal types of art transactions. Second, the substantive concerns presently facing the art investor and existing protections will be discussed. Third, this Comment will examine the protections which are available to the investor in conventional securities investments. Fourth, the proposition that art transactions typically constitute investment contracts will be analyzed in light of Supreme Court decisions which have established the parameters of what will be considered to be an investment contract. Finally, the current position of the Securities and Exchange Commission ("SEC") as to whether traditional art transactions are investment contracts and thereby subject to SEC regulation will be discussed.

7. How wonderful, we are told, that all things rise in price.... Twenty years ago, you might not have got $1,000 for the... painting that now fetches $100,000.... One is left with the impression—indeed it is cultivated assiduously by the largest gaggle of public relations people ever to batten on the flank of culture—that art prices can only go up.... But the unpleasant fact is that no reputation is immune to fashion. The art market is built on it.... If artists who in their day were considered outstanding, whose work was underwritten by the capital and by the social opinions of a powerful empire, could vanish into the oubliette, there is no reason to suppose that the same thing may not happen to their modern equivalents.... What goes up is quite able to come down. It only needs a little crack in the wall of confidence.

Hughes, supra note 2, at 55-56.

8. "Investing in art is a speculative undertaking; at best it is a gamble." Deskbook, supra note 1, at 365. The serious investor must have a profound knowledge of his business in order to succeed. It is advisable for him to specialize in a specific period and medium, and to read widely, consulting trade and price trend magazines such as The International Art Market. Id.
II. Transactions in Art

A. Auctions

Public auction sales account for fifty percent of art transactions. The auction sale has been defined as the “public sale of property to the highest bidder.” The most prominent feature of this selling forum is the unpredictability of the final knock-down price. Because the final sales price results from open bidding, it is accepted as the “fair market value” of the piece for various purposes. Knowledge of the reserve price, the minimum price at which an owner will permit the piece to be sold, would be helpful to the

9. DESKBOOK, supra note 1, at 542.

10. As agent for the owner, the auctioneer solicits ascending bids and determines the final unchallenged bidder. See generally DESKBOOK, supra note 1, at 537-71. It is a well established principle that the public price bid constitutes an offer which is accepted upon the falling of the auctioneer’s hammer; at that moment the sale is complete. See U.C.C. 2-328(2) (1978). The auctioneer is competent to record the sale in a ledger maintained for that purpose and his memorandum is deemed to satisfy the Statute of Frauds. See also N.Y. GEN. OBLIG. LAW § 5-701.6 (McKinney 1978); N.Y. GEN. BUS. LAW § 25 (McKinney 1966).

11. In theory, a public auction should be the ideal way to buy or sell a work of art. The buyer is assured that he is paying only the smallest necessary increment over what a rival purchaser would be willing to pay. The seller is assured that he is receiving the best price that anyone present is willing to pay.


“The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to sell and both having reasonable knowledge of the relevant facts.” Treas. Reg. § 1.170-1(c) (1978).

“Simply stated, auctions establish prices.” DESKBOOK, supra note 1, at 542. Auction cumulative catalogs are excellent sources of price information. The major houses publish annual volumes listing prices obtained for important works. Catalogs for specific auctions are usually available in advance of the sale or on the same day. These ordinarily contain, keyed to individual lots, biographical information about the artist, provenance, conditions of sale, and occasionally, an estimated value.

12. Despite demand, the auction houses have refused to publish reserve prices, arguing that disclosure of this price would convert the auction into a retail sale. DESKBOOK, supra note 1, at 548. “The amount of the reserve has become the last bastion of the auctioneer’s preserve; much akin to a lady’s age, but undoubtedly of interest to a wider audience.” ART WORKS, supra note 11, at 364. However, the houses are ordinarily careful to advise that lots are for sale with reserve unless otherwise indicated. This practice comports with U.C.C. § 2-328(3) (1978), which provides that lots are presumed to be with reserve unless explicitly stated to be offered without reserve. If offered without reserve, a lot may not be withdrawn unless no bid is made within a reasonable time. Id. A New York Senate bill introduced in 1974 which would have required a house to state whether a reserve price existed and its amount (with bidding to start at that price) failed to pass in the face of vigorous opposition. N.Y.S. No. 10111 197th Sess. (1974). See DESKBOOK, supra note 1, at 547-48.
purchaser in establishing the value of a piece. If this price is not met during the bidding, the piece will be withdrawn by the auctioneer.

**B. Galleries**

Purchases may be made privately and confidentially through a gallery or private dealer. A dealer manages a significantly lesser volume of works than the auction house, and may specialize in works of a specific period or origin. He can therefore apply his expertise to the selection and marketing of each piece individually. Frequently, a dealer will be the exclusive representative or distributor of the work of one painter or graphic artist. Thus, a single dealer may possess unique knowledge of that artist's standing in the market and will exercise control over the artist's promotion and distribution. In this way the dealer acts as a market-maker.

A dealer will encourage the sale of art work for two reasons.

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13. An owner wishing to market a piece through a major house must execute a consignment agreement appointing the house as his agent with the agent earning a commission ranging from 12 1/2 to 25% of the price obtained. In addition, there may be a 10% seller's surcharge. The owner bears the consequences of inauthenticity: withdrawal or rescission. See Representing Artists, Dealers and Collectors 487-90 (R. Lerner ed. 1979) [hereinafter cited as Lerner]. See also Art Works, supra note 11, at 355-60.

14. Failure to meet the reserve price is referred to as “burning.” The owner may be forced to sell privately at a substantially reduced price. Lerner, supra note 13, at 174-75. “Burning” might be avoided by self-bidding; however, this practice is prohibited. U.C.C. § 2-328(4) (1978). See also L. Duboff, Auction Problems: Going, Going, Gone, 26 CLEV. ST. L. REV. 499 (1977); N.Y. Times, Nov. 24, 1979, at L44, col. 2 (Stradavarius withdrawn despite bid of $95,000).

15. Obviously, the prices obtained in private dealings would be confidential and not accessible to the general public as auction prices are, but may be known to dealers. Lerner, supra note 13, at 169.

16. The dealer is also in a position to identify potential purchasers and to privately negotiate a price and payment terms more favorable than could be achieved through the auction procedure. Id. at 173.

17. The exclusive dealer may preempt even direct sales by the artist himself, or require prior approval before a direct sale, depending on the terms of the dealer-artist contract. Preemptions may be necessary to prevent the artist from underselling the gallery. See Deskbook, supra note 1, at 366. See also Lerner, supra note 13, at 170-71.

18. “Another unique feature of transactions pertaining to art is that art dealers can create a market for certain items where such a market would not otherwise exist. Manipulation of supply versus demand is possible where the supply of a particular object is limited.” Twaddle, Acquisition and Disposition of Art Objects, IV Art & The Law, Issue 3 at 67, 69 (1979). “Many art galleries aggressively create markets for the works they handle and point this fact out to potential art investors.” Deskbook, supra note 1, at 371. See also note 97 infra.
First, he has a responsibility to the artist he represents or exhibits and will do his utmost to promote the artist’s career. Second, a dealer has a financial interest in selling the works he exhibits. A dealer’s selection of an artist for exhibition is the result of careful business calculation.

A transaction through a dealer is ordinarily in the nature of an outright purchase at a non-negotiable price. A purchaser lacking a high degree of sophistication may be obliged to accept the dealer’s non-negotiable price. Rarely will a dealer disclose information as to past prices obtained which would permit the buyer to determine whether the asking price is fair, that is, whether the price corresponds to the piece’s present value and potential for appreciation.

The gallery selling to strangers may extend a discount to the purchaser of an expensive work. In addition, a buyer dissatisfied with a major purchase may be permitted to return the piece to the gallery for refund or for credit. A gallery, however, frequently enjoys a following of longstanding clientele, who rely upon its expert personnel for counselling and for location of art properties. A fiduciary relation with such clients may arise which would impose a duty on the gallery dealer to make greater disclosure to these buyers.

19. The American Artist Business Letter of September, 1974 suggested as a rule of thumb that the artist be shown (solo) every two or three years, and that the dealer increase sales by at least 20% annually. See Lerner, supra note 13 at 681-82. A dealer attracts buyers for current exhibits through direct mailings, brochures and advertisements in trade and general readership publications. Trade critics are invited to review current shows. See Matter of Friedman, 64 A.D.2d 70, 86, 407 N.Y.S.2d 999, 1015 (2d Dep’t 1978).

20. Artists compete vigorously for shows with established dealers. The dealer may represent the artist on a consignment basis, with the dealer taking a share of from 33% to 60% of sales, or the dealer may purchase from the artist outright at a discount and resell the work for his own account. See Lerner, supra note 13, at 336. The dealer ordinarily resells low to moderately priced works of art at 20% to 100% above cost. DESKBOOK, supra note 1, at 365.

21. See notes 200-05 infra and accompanying text.

22. See note 14 supra.

23. “Gallery owners like to move their stock as well as any merchant and, if asked, will often cut at least 10 percent off the asking price of [an artwork].” Nailing Your Investment to the Wall, GENTLEMEN’S QUARTERLY, Dec. 1974, at 126.

24. As a practical matter, however, most galleries will probably refund only for major purchases because frequent sale reversals are not conducive to smooth business operations.

25. “A reputable dealer’s knowledge is accumulated through years of collecting and researching his subject. . . . We go to a particular dealer not simply to buy [an artwork], but
Installment purchases are available through most galleries. The buyer may take advantage of this feature by paying a portion of the sales price and then immediately reselling the piece to the dealer for resale. The object is rapid profit from the resale of the piece as soon as its price rises, with resale occurring before the final remittance.26

C. The Gallery Repurchase Policy

A New York gallery recently offered twelve nineteenth century European paintings, each selected on the basis of its assessed potential for “significant financial appreciation over the next decade,” and together comprising the “Guaranteed Investment Collection.”27 The offer included a written guaranty to the purchaser which obligated the gallery to repurchase the painting upon request within six or eleven years for 15% to 30% more than the price paid.28 This experimental offer was followed a few months later with the second in a projected series of guaranteed investment collections.29 Again comprised of twelve nineteenth century European paintings, the offer retains the repurchase option, now

because we trust his visual expertise and his knowledge of the field. Essentially, we are also buying his taste and sensibility.” F. FELDMAN & S. WEIL, LEGAL AND BUSINESS PROBLEMS OF ARTISTS, ART GALLERIES AND MUSEUMS 620 (1973).

26. See DESKBOOK, supra note 1, at 368, where the specifics of one gallery’s installment plan are discussed. The gallery charges a 1% monthly finance charge, but assures investors that the value of most art has been increasing at many times that rate. Independent financing is also available through the International Art Registry, Ltd. Id. at 369. Installment sales may be employed to serve a function identical to credit extensions or margin buying on a stock market. Margin requirements are set out in the Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78g (1976).


28. The 15% figure is based on one item, originally selling for $20,000, resellable after six years for $23,000, and after eleven years for $26,000. The guaranty offer is available only to the original purchaser and the offer also stipulates that the work be in unchanged condition at the time of redemption. Letter from Daniel B. Grossman to Maureen Holm (Mar. 5, 1980).

29. See N.Y. Times, Sept. 28, 1980, Magazine, at 84, and Oct. 5, 1980, Magazine, at 99. At 15% over six years, the original terms improved very little, if at all, on projected passbook earnings for the same period. The simple repurchase policy contained in the second offer of the series is at base an open-ended refund offer. See note 24 supra. “[T]he investor has not been restored to status quo since he will have lost the amount of interest which the money would otherwise have earned.” DESKBOOK, supra note 1, at 369. Perhaps the benefits gained by the refund arrangement are similar to those enjoyed by the mere rental of art works, i.e., purely aesthetic. For a discussion of rental offerings, see DESKBOOK, supra note 1, at 379.
exercisable within twelve years, but has eliminated the guaranteed profit. The paintings were selected "based both on their aesthetic merit and on [the gallery's] belief, as experts in the field, that their values [would] rise."30

An offer carrying a repurchase option holds appeal for two reasons. First, the buyer is assured that the gallery has selected each piece for this special collection based upon the gallery dealer's expert assessment of its appreciation potential. Any professional dealer's endorsement of a piece or of an artist may be reasonably interpreted by the lay purchaser as a warranty of future financial promise. The dealer carefully selects the artists he represents; by the mere showing of artists so selected, a dealer may signal to the purchaser that the artist's work is a viable investment.31 By its terms this offer invites explicit reliance on the dealer's overt endorsement.

Second, the promised repurchase shields the investor against unexpected downturns in market value and consequent loss upon resale. Art works are individually executed and therefore unique, and because there is no central exchange market for art works, a single painting is generally not immediately convertible.32 Short-term appreciation gains may be quickly diminished by the costs attendant to ordinary resale.33 The repurchase policy gives the investor the option to recoup his entire outlay immediately. Particularly in view of temporal and monetary burdens, resale back to the gallery may prove, as a practical matter, to be the investor's only means of liquidating the investment property.34

D. The Mail Order Membership Purchase

Limited edition prints, ceramics and books are currently offered

30. See notes 171-72 infra and accompanying text.
31. See note 25 supra.
32. The typical art investor is no match for the true art expert, to whom the most sizeable profits inevitably fall. See DESKBOOK, supra note 1, at 365. The so-called country auction where the city slicker might once snap up for a song a Revere salver or a federal highboy is as distant a memory as the nickel newspaper. Says Scudder Smith, editor of Antiques and Arts Weekly, "You look around some of these little country auctions and there are 25 well-known dealers there." TIME, Dec. 31, 1979 at 52.
33. See DESKBOOK, supra note 1, at 365.
34. See notes 220-24 infra and accompanying text for a discussion of similar investor reliance in a securities context.
by mail order. For example, a Manhattan-based print marketing group readily affirms its purpose as the offer by subscription of selected original graphics believed to possess a high average appreciation potential. This distributor has enjoyed mounting success since commencing operations in 1972, and continues to enlarge its national membership.

For a twenty-five dollar membership fee applicable to the first purchase, the investor receives a monthly series of portfolios compiling current print offerings selected on the basis of the distributor's expert assessment of each print's appreciation potential. While the promotional material points out the aesthetic merit of the prints, the offering is emphatically investment-oriented. The distributor acts as the exclusive representative of the artists featured, and thus occupies a controlling position in the market for these works.

The prospective purchaser is cautioned against buying any artwork without first seeking professional investment advice. The distributor extends such advice and invites the investor's explicit reliance on its recommendations.

The mail order print distributor offers members a complete package of investment services. The distributor functions throughout the process from offer to sale as expert advisor, sales agent and seller. The enormous breadth of prices for the prints ensures ap-

37. In response to an inquiry, the prospective member receives an introductory letter which persuasively demonstrates the appreciation potential of prints, "when chosen by experts," with examples of annual appreciation rates attained for past offerings. The sales literature is persuasive, and it encourages members to rely on the distributor's professed expertise in compiling the print investment portfolio, as well as on its optimistic predictions of the rise in future value of each selection. Letter from Original Print Collectors Group, Ltd. to Maureen Holm, (Mar. 20, 1980).
38. The letter from the Original Print group notes that a dealer's overhead results in prices considerably higher than those available to members. It is also pointed out that as the membership rolls expand, the organization "can negotiate for better prices and offer a wider selection [of prints]." Id.
39. The bi-monthly newsletter published by the distributor contains specific investment recommendations. To facilitate trading among members, the distributor provides market information and publishes "bids" which have been received for prints held by other members.
40. The expert art advisor, sales agent and seller perform functions analogous to those
peal to a broad public of equally varying economic means.\textsuperscript{41} As this investment plan contemplates that members rely on the distributor in each of its capacities, the investor's readiness to purchase by mail order even very expensive works is quite remarkable.\textsuperscript{42}

E. The Volume Discount Purchase

Galleries and other art merchants with increasing frequency are engaging artists to specially prepare a series of lithographs or other art works to be distributed in bulk purchase to private buyers.\textsuperscript{43} Through its exclusive relationship with the artist and sole control over distribution of the works, the art merchant is in a position to offer the works at a price significantly below the aggregate fair market value of the works if each were sold individually.\textsuperscript{44}

The fair market value of the work may be established by means of a formal appraisal statement which is offered as a feature of the investment plan. This formal appraisal is used by the purchaser who intends to resell the work to calculate the profits to be gained and by the purchaser donating the work to substantiate tax deductions. A list of suitable donees may also be provided by the distributor. The investor need never take actual possession of the works; under the plan the merchant arranges for direct delivery to the selected donee or resale purchaser.\textsuperscript{45}

\textsuperscript{41} Prices for the print offerings range from $100 for a contemporary print to $28,000 for Lautrec's "Aristide Bruant", and include framing. In December, 1979, the Lautrec sold at auction for the record price of $26,000. \textit{See} \textit{Time}, Dec. 31, 1979, at 47 and note 11 \textit{supra}.

\textsuperscript{42} The distributor reports that Old Master prints sell out immediately. Letter from Original Print Collectors Group, Ltd. to Maureen Holm (Mar. 20, 1980).


\textsuperscript{44} In \textit{Art Appraisers of American}, the limited edition numbered 500 for one series and 1000 for another. Most limited editions are restricted to 200 to 300 reproductions ("pulls"). [1976] \textit{Fed. Sec. L. Rep. (CCH)} \$ 87,079.

\textsuperscript{45} These features are all included in the \textit{Art Appraisers}’ offer. \textit{See} note 43 \textit{supra}. Also included is an opinion of counsel that the works are eligible for capital gains treatment. The Art Appraiser offering has served as a format for similar offerings. \textit{See}, e.g., Metropolitan Graphic Arts Distributors, Ltd., SEC Staff Reply Letter, May 31, 1977, also discussed at note 215 \textit{infra}; Anthony R. Pratley, [1979] \textit{Fed. Sec. L. Rep. (CCH)} \$ 82,325.
F. Art Advisors

As art ownership becomes popularized, market stratifications naturally develop, creating the opportunity for independent art advisors, of varying qualifications and reputability, to serve potential clientele of varying economic means. Understandably, the appeal of such advice increases proportionally to the sum invested. In each of the above transactions, investors were offered the expertise of an art advisor as an essential and attractive component of the purchase plan. Art advisors have proliferated in major cities, including New York, serving as direct consultants to individuals and to corporations. Advisors vary widely in pricing, philosophy and qualifications. Because they are unaffiliated, unlicensed and unregulated, great care must be exercised in the selection of an art advisor.

46. The advisory function of the private gallery owner is not easily categorized. He may not expressly hold himself out to the public as an art advisor, yet he must inevitably make statements incidental to any art purchase. The purchaser of works exhibited in private galleries may elicit from the professional dealer information of an advisory or expert nature, which, to the extent granted, will be relied upon. See note 25 supra.

47. See generally Rosenbaum, Choosing the Chooser: How to Pick an Art Consultant, Artnews, May, 1979, at 52-58. Corporate entities increasingly fund the arts, with annual gifts totalling in excess of $250,000,000. See Metz, The Corporation as Art Patron: A Growth Stock, Artnews, May, 1979, at 40, 43. Corporations have also become an acknowledged and much solicited major consumer of artistic production. See Sloane, supra note 3, at 47. In some instances corporate departments and vice presidencies have been established to make acquisitions. Id. at 40. In-house as well as independent art consultants are hired, and the independents target corporations with advertisements in the trades. The advisory service may take the form of newsletter distribution to subscribers, individual counselling, or the supply by Sotheby Parke Bernet to a major bank of factual art research studies. See Time, Dec. 31, 1979, at 55. Sotheby Parke Bernet does not make any financial recommendations; rather, it supplies Citibank's Fine Arts Management Service with facts concerning past market performance along with curatorial analyses, but without any investment prognoses. Economic recommendations are the province of the bank's own advisors. Telephone conversation with Manager, Institutional Services and Market Research, Sotheby Parke Bernet, (Apr. 1, 1980). Mr. C. Hugh Hildesley of Sotheby Parke Bernet recommends five years experience in the field of specialization for persons performing appraisal functions. See Lerner, supra note 13, at 182. Similar to appraisers, art advisors must be equipped to estimate current market values and to perform authentications.

49. "[T]he most obvious sources of guidance—art experts—are rarely accessible to buyers, and there are no licensing agencies, qualifying examinations, referral agencies, or ethical committees comparable to those in the medical or legal professions to guide the nonprofessional." Art Works, supra note 11, at 1063.

There appears to be no precise definition of an art expert. Dudley Easby, Secretary of the New York Metropolitan Museum of Art, declared: 'Some writers have preferred to use the word 'authority' rather than 'expert', but I think we'll agree that he might
III. Substantive Concerns and Existing Protections for the Art Investor

There are four main concerns to be satisfied in relation to the purchase of art as an investment property. It is self-evident that the art purchaser assumes like every buyer of personalty, that the seller holds and can transfer unencumbered title to the art work in return for the purchase price. This fundamental assumption is implemented by the Uniform Commercial Code which imposes on the seller a warranty of title in every sales contract. The remaining concerns, authenticity, present value and appreciation potential merit further discussion.

be a dealer, museum curator, artist, art historian, professor, conservator, researcher, metallurgist, chemist, X-ray man, or even a nuclear physicist. One thing all these people have in common among themselves and in common with other expert witnesses is some special knowledge based on long study and experience. Another thing they have in common—and this is contrary to popular belief—is that they are not possessed of such infallibility.'

Id. at 1063 n.50. (quoting Easby & Collins, The Legal Aspects of Forgery and the Protection of the Expert, N.Y. METROPOLITAN MUSEUM OF ART BULL., Feb. 1968, at 258.)

50. A New York gallery, located in the heart of the financial district, offers free consultations designed to prepare investors to deal more effectively with art merchants.

51. The leading decision relating to the warranty of title for an art work is Menzel v. List, 49 Misc. 2d 300, 267 N.Y.S.2d 804 (Sup. Ct. 1966), modified as to damages, 28 A.D.2d 516, 279 N.Y.S.2d 608 (1st Dep't 1967), rev'd as to modifications, 24 N.Y.2d 91, 246 N.E.2d 274, 298 N.Y.S.2d 979 (1969). The appropriate measure of damages was the fair market value of the work at the time of its return to the rightful owner. Accord, Itoh v. Kimi Sales, Ltd., 74 Misc. 2d 402, 345 N.Y.S.2d 416 (Civ. Ct. 1973). The loss of artwork by theft is a matter for intense international concern. See Feldman, To Catch a Thief, ART & THE LAW, Jan. 1975, at 3. See also H.R. Rep. No. 13446, 89th Cong., 2d Sess., 112 CONG. REC. 5386 (1966) providing for the creation of a National Registry of Art seated in the Smithsonian Institute in Washington. While not enacted, this bill would have mandated criminal sanctions for false information supplied to the Registry, but filing was to be voluntary. The registration of art was analogized to other filing systems intended to promote certainty in commercial transactions such as real estate, copyright and securities. See American Bar Assoc. Reports, Vol. 151, 2495-96 (1966). Museums and art dealers’ associations have begun to maintain their own records of stolen art. See also Art Works, supra note 11, at 1055-91. For a discussion of attempts to control forgeries and national treasures acts, see id. at 527-626. Great Britain recently intervened to prevent the exportation of the “Codex Leicester” (DaVinci).

52. U.C.C. § 2-312 (1978). The statutory measure of damages is the difference between the value at the time and place of delivery and the value the goods would have had had the representation of title been valid. U.C.C. § 2-714(2) (1978). The prudent art investor may nevertheless wish to insist on a covenant of title.
A. Authenticity

The investment art purchaser must be convinced of the identity of the piece, that it is the piece it is represented to be or the work of the author to whom it is attributed.\(^53\) Until recently the question of authenticity in a transaction was governed by the doctrine of \textit{caveat emptor} and common law fraud principles, under which the investor bore the responsibility for his own protection.\(^54\) One means of self-protection is to seek independent authentication; however, many experts are reluctant to perform authentications for fear of liability.\(^55\) Further, where the ratio of the authentication fees to the cost of the piece is disproportionate, the purchaser may decide to just take the risk.\(^56\)

In 1968, the New York legislature amended the General Business Law to add a provision which makes an art merchant’s representations as to authorship of art works part of the basis of the bargain.\(^57\) The art merchant’s representations are considered affirmations of fact and therefore deemed to be express warranties.\(^58\) The

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53. See N.Y. Penal Law § 170.45 (McKinney 1975), which makes it a class A misdemeanor to render any object so that it "appears to have an antiquity, rarity, source or authorship which it does not in fact possess." \textit{Id.}

54. An action in common law fraud was of limited effectiveness. Because of the requirement of scienter, merchants selling in good faith were not liable for fraud. See Restatement of Torts § 526(b) (1938) and W. Prosser, Law of Torts 177-80 (4th ed. 1971).

55. See Findlay v. Duthuit, N.Y.L.J., Oct. 10, 1980, at 3, col. 2 (New York art dealer unsuccessfully sued Paris-based art expert for classifying as "fake" a Matisse sold by the dealer for $260,000; no personal jurisdiction). See also N.Y.A. No. 4818 189th Sess. (1966), a bill introduced but not enacted by the state legislature which would have provided a qualified privilege for expressions of opinion relating to authenticity. The expert would have been liable only in the event a work pronounced by him to be a forgery was later shown to be authentic. For a discussion of this bill, see DESKBOOK, supra note 1, at 414-19.

56. "An art purchase often results from a buyer's sudden impulse; he does not pause to obtain information relating to the property purchased or engage in the formalities commonplace in transactions involving other kinds of property of like value." DUFFY, supra note 6, at 2.

57. N.Y. Gen. Bus. Law § 219-c (McKinney Supp. 1979). Under § 219-c(2), the merchant may select the appropriate terminology to indicate whether the piece is unequivocally the work of a named author, attributed to a named author, or of the school of a named author, as those terms are used in the trade.

58. The new section was intended to complement the warranty provision contained in U.C.C. § 2-313 (1978). See Legislative Memorandum of Attorney General Relating to Article 12-D contained in ART WORKS, supra note 11, at 405-08. The commentary to the U.C.C. provision indicates that whether a seller's affirmations of value were intended as a basis of the bargain is a question of fact. U.C.C. § 2-313, commentary, Point 8. (1978).
remedies of rescission or damages are available to the injured purchaser, depending upon whether the warranty is construed as a condition or as a covenant. Additionally, the General Business Law makes it a class A misdemeanor for any person to falsely certify authenticity, whether orally or in writing.

In Dawson v. Malina, an action was brought under the new section 219-c to rescind the purchase of Chinese ceramics and other art objects sold by a New York dealer. The dealer attributed the ceramics, by oral representation and by a written bill of sale, to various dynastic periods and traced their provenance. Subsequent consultations with art scholars in New York and abroad caused Dawson to question the accuracy of the attributions and provenance.

Dawson argued that the warranty created by section 219-c required that the pieces conform in all respects to the dealer's descriptions. The Dawson court granted rescission but refused this stringent standard, requiring instead that the purchaser bear the burden of proving by a preponderance of the evidence that the dealer's representations were made without a reasonable basis in fact. The court applied this lesser standard because the expert witnesses called by both parties could not state unqualifiedly to which period a piece belonged, reasoning that the defendant dealer's unguarded attributions therefore could not have been factually based. The Dawson court construed section 219-c as intended to convert a dealer's statements, perhaps mere expressions of opinion in other sales contexts, to express warranties.

Dawson also makes clear that a dealer's representations as to authorship are directly related to the issue of value. The buyer relies on the dealer's identification of the piece as a basis for his

62. 463 F. Supp. at 463. Dawson bought eleven objects of Chinese art for a total purchase price of $105,400. Id.
63. Id. at 465-66.
64. Id. at 467.
65. Id. at 470-71.
purchase decision. The warranty in Dawson was construed as a condition which if breached would justify rescission of the transaction. In other instances, the warranty may be construed as a covenant, with a breach of the express warranty to be remedied by monetary damages. Depending on the facts surrounding the transaction, the damage award could be substantial. Such facts are present when the dealer knows, for example, that the buyer intends to resell in reliance upon the dealer's representations of present value. It is conceivable, but probably unlikely, that section 219-c could be construed to convert the dealer's representations of appreciation potential to express warranties.

B. Present Value

Present value and appreciation potential of art work are conceptually distinct. The purchaser buying on the basis of perceived or represented present value makes a non-speculative investment. The purchaser buying on the basis of perceived or represented appreciation potential makes a speculative investment. Each factor alone or in combination may motivate a purchase.

Satisfaction of the piece's present value is governed to an extent by section 219-c, but only to the extent that value is a natural concomitant of authenticity. The statute falls short of imposing any affirmative duty on the seller not to overreach the buyer by demanding a price which, because of his superior market or other knowledge, he knows to exceed the true value of the piece.

The common law recognizes that sales transactions frequently occur between parties who lack equal knowledge concerning the object of the sales contract or the market in which it is traded. This principle is well illustrated by transactions in corporate securities. The policy which underlies the intricate body of securities law is one of full and fair seller disclosure to the investing public.

66. In each art purchase one or the other factor may predominate. Regarding the transactions enumerated in the preceding section, it will be noted that in the mail order offer the speculative aspect predominates. The volume discount purchaser is attracted by a bargain offer and calculates an immediately identifiable return represented by the disparity between the purchase price and resale price. A simple repurchase option contains no inherent appreciative gain. See note 153 infra.

67. See Restatement of Contracts § 472(b) (1932); 12 Williston, Contracts §§ 1497-1499 (3d ed. 1970).

68. See notes 101-10 infra.
It is obvious from the dollar value of the purchase successfully rescinded in Dawson v. Malina that Dawson had significant advisory and financial resources at his disposal, and thus could force satisfaction from the seller. However, a considerable portion of the increasingly profitable art business is comprised of purchases of moderately priced works by persons who lack Dawson's resources.69

C. Information to Determine Value

Original prints70 are a good example of affordable art which has enjoyed enthusiastic response from a broad-based buying public. Two states have passed legislation71 to curb abuses predictably attendant to lucrative sales, and similar legislation has been introduced in the New York State Assembly.72 The justification for legislative action, as described in the New York proposal, is the need to enhance the buyer's opportunity to make a reasonable assessment of the print's monetary value.73 This need is met by requiring seller disclosure of information relevant to the print's uniqueness and scarcity.74 The New York proposal specifically acknowledges that the art merchant is typically in a position to know much more about the work than the investor.75 To correct this imbalance, the

69. "[C]ollecting valuable objects is no longer the preserve of the rich. At Sotheby's Los Angeles branch, which recorded a 1978-79 turnover of $13.7 million, 50% of all items on sale go for less than $300." TIME, Dec. 31, 1979, at 50.

70. The general requirements of an original print are: (1) that the artist alone created the master plate or woodblock, (2) that the reproduction ("pulling") was supervised by the artist, and (3) that the finished print was approved by the artist. See What is an Original Print? (Principles Recommended by the Print Council of America) ART WORKS, supra note 11, at 441.

71. California, CAL. CIV. CODE §§ 1740-1745 (West 1973) and Illinois, Ill. Sales Code §§ 361-369 (Smith Hurd Supp. 1972). The laws are similar in that each requires identical disclosure and provides for treble damages or fines for violation. The Illinois act, however, excludes prints sold by the artist and applies both to wholesale and retail sales. The effort to pass federal legislation in this area has proven unsuccessful. See ART WORKS, supra note 11, at 411-35, including an exchange of memoranda between the bill's draftsman and the Art Dealers' Association.

72. N.Y.A. No. 10809, 203d Sess. (1980). This bill was preceded by the N.Y. City Consumer Protection Law, Regulation 30, which prohibits the deceptive labeling of posters as "limited editions." This deceptive practice would presumably be prosecuted under the New York Martin Act. See notes 128-32 infra. The bill would amend the New York General Business Law by adding a new section 222.


74. Id.

75. N.Y.A. 10809, § 1 Legislative Findings and Intent.
bill itemizes informational details which must be provided by the seller, including: the artist’s identity, the size, date and number of editions, the medium used, whether the artist oversaw or approved production, whether each print is hand signed, and whether the plate is still employable. The affirmation of any of these factual details constitutes an express warranty within the meaning of section 219-c of the General Business Law.

The merchant may disclaim knowledge of any detail, but a disclaimer is ineffective absent a showing that the information was not ascertainable despite reasonable inquiries. Rescission and restitution or damage relief is available to the purchaser if the seller fails to supply the information or supplies erroneous information. The buyer may recover treble damages from the dealer who wilfully withholds, falsely supplies or falsely disclaims knowledge of the relevant information.

The proposed statute expressly acknowledges as its model the law governing investments in corporate securities. Its policy is identical to the policy of full and fair disclosure embodied in the laws governing securities transactions. The monetary value of a print is measured by its uniqueness and scarcity. The disclosure mandated under the print legislation is designed to shield the purchaser against deceptive use of photographic reproductions and misleading numbering schemes. Similar disclosure requirements for the sale of one of a kind paintings and sculptures have not been legislated, but guidelines for the content of such legislation can be modelled on Internal Revenue Service (“IRS”) procedures.

An example of the kind of data which should be contained in a typical appraisal is included below. This relates to the valuation of art objects, but a similarly detailed breakdown can be outlined for any type of property. Appraisals of art objects, paintings in particular, should include:

1. A complete description of the object, indicating the size, the subject matter, the medium, the name of the artist, approximate date created, the interest transferred, etc.
In 1968, the IRS assembled an Art Advisory Panel to aid it in reviewing deductions claimed by taxpayers for donated art properties. The IRS requires that the asserted fair market value of the donated piece be substantiated. Substantiation can be achieved only through disclosure of the economic state of the relevant market and the artist's standing within that market. The IRS points out that evidence of the actual sales price is unpersuasive absent a showing that the parties were fully informed as to all relevant facts. The factors reviewed by the IRS are general enough to permit their application to sales in most art media. A disclosure by the seller of these facts would help to close the gap between the knowledge possessed by the art merchant and the typically lesser knowledge of the art purchaser.

Perhaps fair dealing would be encouraged if art merchants were subjected to sanctions within their own community. Art dealers may complain, however, that the sheer diversity of art merchants, which is a function of variances in type and price of art properties, does not readily lend itself to a uniform code of professional ethics enforced by membership suspension or other public disapproval.

However, absent a professional sanctioning mechanism, a dealer may quietly refund the purchase price to a dissatisfied buyer without significant adverse effect on the dealer's reputation. Unfortunately, the dealer may refuse altogether to refund the purchase

(2) The cost, date and manner of acquisition.
(3) A history of the item including proof of authenticity such as a certificate of authentication if such exists.
(4) A photograph of a size and quality fully identifying the subject matter, preferably a 10" x 12" or larger print.

Id.

83. See Rev. Proc. 66-49 § 3.03(5), which provides in part:
(5) A statement of the factors upon which the appraisal is based, such as:
(a) Sales of other works by the same artist particularly on or around the valuation date.
(b) Quoted prices in dealers' catalogs of the artist's works or of other artists of comparable stature.
(c) The economic state of the art market at or around the time of valuation, particularly with respect to the specific property.
(d) A record of any exhibitions at which the particular art object has been displayed.
(e) A statement as to the standing of the artist in his profession and in the particular school or time period.

price of a minor work valued at just a few hundred dollars for the reason that frequent rescissions are not conducive to smooth business operations. The unfair burden then falls on the buyer to expend time, money and aggravation in litigation or to simply keep the unwanted or overpriced work.

D. Appreciation Potential

Art properties, like corporate shares and other investment vehicles, are traded on a fluctuating market. As brokers or dealers of corporate securities analyze trends on the stock market, so are signals of trends in market performance discernible by experts in the art market. Analogs to the predictions of broker-dealers or to inside tips can be discerned. In the context of this examination of the art market, a purchase made expressly with a view to appreciation potential has been characterized as a speculative investment. As a practical matter, however, some consideration of appreciation potential likely accompanies most art purchases, if only as the inevitable result of the widely publicized rise in art prices generally.

Seller representations of appreciation potential are explicit in the case of the mail order prints and the guaranteed investment collection gallery offer. Moreover, buyers are invited to rely on the representations as deriving from expert knowledge. It appears to be axiomatic among reputable gallery dealers that representations of appreciation potential are inappropriate. The recognition of the conflict which inheres between the selling and advisory functions probably dictates the restraint of these dealers. However, even a comment on an artist's recent sales gains could be interpreted by the purchaser as a representation of appreciation potential. It may frequently be difficult to ascertain whether such seller representations induced the purchase, and the extent to which the

85. A merger or acquisition may affect the value of a corporate share, embargoes or the discovery of a new lode will affect the price of diamonds, and museum acquisitions or private trading may affect the value of a work of art.

86. "For the past 15 years or so, collectors, dealers, auction houses and their willing accomplices, journalists, have been moved to pleasure, then wonder, and now to a sort of popeyed awe at the upward movement of art prices. . . . [I]ts present function is to become a new type of bullion." Hughes, supra note 2, at 56.

87. See text accompanying notes 27-42 supra.

buyer relied on the representations as a basis of the bargain.

Unfortunately, while a purchase may be actively induced in most cases, current law abandons the dissatisfied buyer to an uncertain remedy. Recourse beyond the harsh doctrine of *caveat emptor* and common law fraud principles in the purchase and sale of art properties is appropriate. The law imposes no duty on the art merchant to correct a purchaser's inaccurate notions of a work's future value, although an art advisor consulted for his expertise would likely bear such a duty as a natural concomitant of his agency function.

It is evident that the investor in art properties occupies a precarious position within the market, and must frequently rely on persons whose interests may be adverse to his own. The investor's disadvantage has been little improved by piecemeal legislative solutions which, while modelled on the legal principles governing other investment markets, cannot be effectively exploited. The protective mechanisms employed in the securities investment market, and their underlying policies, are surveyed in the next section with a view to their application to art investments.

**IV. Traditional Investment Markets**

The investment vehicles most familiar to the public are corporate stocks and bonds. The shareholder, like any investor, commits funds to a purchase with the expectation that the investment

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89. See note 67 supra.
90. See note 54 supra.
91. When the principal employs an agent, the law presumes that he does so in order to secure to himself the benefits of the agent's skill, experience or discretion, and to reap the fruits of the performance of the undertaking. The law presumes that he expects—and it gives him the right to expect—that the agent so employed will endeavor to further the principal's interests, and will use his powers for the principal's benefit.
F. MECHEM, LAW OF AGENCY § 500 (4th ed. 1952). The agent has a duty to give the principal notice of all material facts which come to his knowledge. Id. § 541.
92. "The most common feature of stock is the right to receive dividends contingent upon an apportionment of profits." Tcherephrin v. Knight, 389 U.S. 332, 339 (1967). Securities may also take the form of limited partnership interests in oil and gas ventures, see, e.g., Bayoud v. Ballard, 404 F. Supp. 417 (N.D. Tex. 1975), promissory notes in some contexts, El Khadem v. Equity Securities Corp., 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974), and fur-bearing animal breeding, Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (chinchillas); Kemmerer v. Weaver, 445 F.2d 76 (7th Cir. 1971) (beavers). In such instances an investment contract is present. See discussion at notes 176-85 infra.
will return a profit as the result of the efforts of someone other than himself.\textsuperscript{93} Securities which meet certain criteria may be listed for trading on a major exchange.\textsuperscript{94} These central exchanges are continuous auction markets in which a buyer or seller can execute transactions through members of the exchange.\textsuperscript{95} Price information is available to all traders through a uniform quotation system.\textsuperscript{96} Unlisted securities or odd lots are traded over the counter by members of the National Association of Securities Dealers.\textsuperscript{97} New issues are usually promoted through the sales efforts of a single market-maker\textsuperscript{98} in much the same manner as the exclusive art dealer or distributor promotes artists.\textsuperscript{99}

A. Investor Protection through Regulation

It is the fundamental purpose of the body of laws which govern securities transactions to protect the investing public. This goal is
achieved through three distinct types of regulatory devices. These devices are: 1) pre-offer registration of securities, 2) antifraud provisions, and 3) the registration of traders and advisors.\footnote{100}

\textbf{1. Disclosure: The Securities Act of 1933}

Congress enacted the Securities Act of 1933\footnote{101} (the "1933 Act") with the aim of "restor[ing] the confidence of the prospective purchaser in his ability to select sound securities."\footnote{102} The 1933 Act broadly defines what constitutes a "security."\footnote{103} The philosophy of the legislation is emphatically one of full and fair disclosure by the seller.\footnote{104} The harsh doctrine of \textit{caveat emptor} is replaced by a procedural framework which enables the prospective investor to make an informed investment decision.

The Securities and Exchange Commission is the government agency charged with the administration and enforcement of the statute, and has substantial rule-making,\footnote{105} investigative and sanctioning authority.\footnote{106} The SEC issues public policy statements in...
the form of releases, interpretive letters, and "no-action" letters.\textsuperscript{107}

The registration statement and offering prospectus required to be filed for review by the SEC\textsuperscript{108} describe the scope and method of the offering, the security or interest offered and the business dealings of the corporate issuer and its key personnel.\textsuperscript{109} Financial statements and advertising must also be filed. No sales may be effected pending SEC approval.\textsuperscript{110}

2. Exemptions

Non-public offerings are exempt from the registration require-

\begin{footnotes}
\textsuperscript{107} "No-action" letters are issued in response to written inquiries from private counsel relating to proposed transactions. The facts surrounding the offer are set out, ordinarily with an opinion of counsel that the offering does not constitute the offer of a security within the meaning of § 2(1) of the 1933 Act. The SEC staff in a reply letter indicates whether enforcement action will be recommended. Such position statements have no legal authority, as is typically pointed out by the SEC:

Because this position is based upon the representations made to the Division in your letter, it should be noted that any different facts or conditions might require a different conclusion. Further, this letter only expresses the Division’s position on enforcement action and does not purport to express any legal conclusion on the question presented.

The above cautionary statement appears in every reply letter.


\textsuperscript{109} See Perspective, supra note 95, § 5.06; 3A Bloomenthal, supra note 94, §§ 7.08, 7.09. More specifically, these items are listed as (1) statement of proposed use of proceeds; (2) table of debt and equity securities; (3) list of underwriters; (4) five-year profit and loss statement; (5) five-year history of business operations; (6) description of relevant physical properties; (7) organization and principal shareholders, § 16-type transactions; (8) threatened or pending litigation; (9) description of security (voting, non-voting, etc.); and (10) detailed information concerning directors, including five-year history of business experience, age, remuneration and shareholdings or options. Id.

\textsuperscript{110} The waiting period is ordinarily 20 days. The SEC reviews all these materials for their completeness and accuracy, and notes any deficiencies requiring amendment. See 15 U.S.C. § 77h (1976). A “stop-order” may enjoin the issue. Id. § 77h(d). See also 1 Loss, supra note 100, at 180. The enforcement sections 11 and 12 encourage careful preparation of the registration statement and prospectus. The registrant is liable to purchasers for false or misleading statements contained in or omissions from the offering documents. See Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), holding that such statements are those which if correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question. The offeror of securities in violation of § 5 is liable to purchasers of the unregistered securities. A general remedy is provided for defrauded purchasers. 15 U.S.C. § 77k (l) (1976). The clear policy of the Securities Act of 1933 is to assure the availability to purchasers of basic, reliable information in advance of sale. The investor should gain a fair picture of both affirmative and negative factors. See Adato v. Kagan, 589 F.2d 1111, 1115-16 (2d Cir. 1979).
\end{footnotes}
ments of the 1933 Act on the theory that the public benefits to be derived from registration are too remote to justify the filing burdens.\footnote{1} The offerees, however, must be "persons able to fend for themselves." The ability to fend for oneself depends on two factors: 1) access to the same kind of information as that which would be disclosed in a registration statement and 2) the sophistication of the offerees.\footnote{2} Although the actual number of offerees is not determinative, an SEC rule assures an exemption for offers made to small groups of thirty-five or fewer,\footnote{3} provided the offerees do not purchase for resale.\footnote{4}


\footnote{2} See Securities & Exchange Comm'n v. Ralston Purina Co., 346 U.S. 119, 126 (1953); 3 Bloomental, supra note 94 § 4.05[5]. See generally Hicks, supra note 111.

\footnote{3} Rule 146, 17 C.F.R. § 230.146 (1978). The offer to a single person may constitute a public offering. Securities & Exchange Comm'n v. Ralston Purina Co., 346 U.S. at 125. An offering to diverse and unrelated groups would have the appearance of being public. See Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979). The thirty-five person limit may not be thwarted by successive offers to groups of thirty-five, since such offers may be deemed "integrated" and the offeree number therefore counted in the aggregate. See Securities Act Release No. 4552 (1962), listing five factors to be applied in testing for integration: (1) whether the different offerings are part of a single plan of financing; (2) whether the offerings involve the issuance of the same class of security; (3) whether the offerings are made at about the same time; (4) whether the same type of consideration is to be received; and (5) whether the offerings are made for the same general purpose. For a no-action letter response denying application of Rule 146, see Photographic Artists, Ltd., note 212 infra and accompanying text.

\footnote{4} It is common practice to have buyers present a letter stating that the purchase is not intended for resale. 1 Loss, supra note 100, at 665. The mere holding of the asset to obtain capital gains treatment or to profit from a market rise does not afford a statutory basis for the exemption. Id. at 668-69 (citing Securities Act Releases Nos. 3825 (1957) and 4164 (1959)). See also notes 43-45 supra (relating to the art market and to the offering in Art Appraisers of America). The Rule 146 exemption is frequently exploited in connection with tax shelter offerings. Perspective, supra note 95, § 6.01. In Art Appraisers of America, some investors purchased for tax benefits, others for resale.
As dictated by the policy of protective disclosure to investors, the Commission may revoke exemptions at any time. Moreover, exemption does not immunize any offer or its offerors from liability under the antifraud provisions contained in section 17 of the 1933 Act and in section 10b of the Securities Exchange Act of 1934.

3. The Securities Exchange Act of 1934

The heart of the 1934 Act is the antifraud provision contained in section 10b as implemented by Rule 10b-5. The purpose of the provision is to ensure fairness in the purchase and sale of securities. Any transaction effected by means of deception, manipulation or fraud violates this protective policy. The provision goes beyond the dictates of sections eleven, twelve and seventeen of the 1933 Act, which prohibits misstatements or omissions in filing documents, by prohibiting all misleading statements of material fact made in connection with the transaction. A material fact may be any information which might influence the investment decision of the reasonable investor. The provision has been construed as intending to relax the common law fraud standard in order to effec-

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115. See 1 Loss, supra note 100, at 626 (citing examples of grounds for revocation, such as prior convictions and materially misleading information).
117. Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
   (1) to employ any device, scheme, or artifice to defraud,
   (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
118. "Rule 10b-5 was promulgated ... to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges." Securities & Exchange Comm'n v. Texas Gulf Sulfur Co., 401 F.2d 833, 847-48 (2d Cir. 1968), cert. denied, 394 U.S. 976, rehearing denied, 404 U.S. 1064 (1969).
In the context of an art transaction, a statement of material fact could be any representation as to authorship, present value or appreciation potential made by the seller. Rule 10b-5 would impose liability on the seller for misleading the purchaser as to any of these elements of the bargain. Further, because Rule 10b-5 was designed to ensure that all investors trade on an equal footing, if applied to art transactions it might impose an affirmative duty on the dealer to disclose material facts solely within his superior knowledge.

B. Regulation of Traders

To protect the investing public against unqualified or unscrupulous traders, broker-dealers are required under section 15(a) of the 1934 Act to register with the SEC. To ensure fair trading practices, the antifraud provisions of section 10b are extended to broker-dealers under sections 15(c)1 and 2. Also, the SEC has independent sanctioning and investigative powers under the 1934 Act to ensure fair trading practices.

The broker trades in securities as agent for his customers but


121. "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks, which market risks include, of course, the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital." Securities & Exchange Comm'n v. Texas Gulf Sulfur Co., 401 F.2d at 851-52.

122. 15 U.S.C. § 78o(a) (1976). The information elicited through registration relates to educational background, past business dealings and any prior misconduct. The registrant submits to the jurisdiction of the Commission once application is made. Blaise D'Antoni & Associates, Inc. v. Securities & Exchange Comm'n, 290 F.2d 688 (5th Cir. 1961). "Registration is intended to prevent fraudulent or unqualified persons from entering the securities business, to supervise their activities once registration has been achieved, and to remove them from registration if they fall below any of the statutory standards." 1 Loss supra, note 100, at 34.

the dealer trades as principal for his own account. Confusion may sometimes arise because the broker's professional obligation to his client may conflict with the dealer's personal interests. The broker-dealer must make full disclosure to his customers of possible conflicts or other material facts or face liability under the relevant provisions of the Act. The broker-dealer is barred from over-reaching his client, and prohibited from charging excessive prices, making unfounded recommendations, and recommending securities for purchase not suitable for the particular customer.

The art purchaser who may be similarly confused when a dealer acts in the dual capacity of advisor and seller enjoys no similar protections. Also, the buyer who seeks rescission asserting that an art purchase is not "worth" the price paid, may have a valid but incognizable claim.

1. Investment Advisers Act of 1940

The Investment Advisers Act ("Adviser Act") contains a system of registration and regulation of investment advisers comparable to that contained in the 1934 Act for broker-dealers. An investment adviser may be anyone who advises others, either by personal consultation or through publications, as to the value of securities or


125. See generally Charles Hughes & Co. v. Securities & Exchange Comm'n, 139 F.2d 434 (2d Cir. 1943); PERSPECTIVE, supra note 95, § 21.02 and cases cited therein. Examples of other prohibited practices are "churning" and "scalping." Churning occurs when the broker/dealer is the sole or dominant market maker in a particular security and does not make full disclosure of the nature of the market, or where he causes transactions for his customer's account which are excessive in view of the financial resources or character of the account. See, e.g., Carras v. Burns, 516 F.2d 251 (4th Cir. 1975); Faturik v. Woodmere Securities, Inc., 442 F. Supp. 943 (S.D.N.Y. 1977). Scalping occurs when the broker/dealer recommends the purchase of a security without disclosing a practice of purchasing such securities before making the recommendation and then selling these at a profit when prices rise. See, e.g., Securities & Exchange Comm'n v. Capital Gains Research Bureau, 375 U.S. 180 (1963).

who makes recommendations as to their purchase or sale. In this way, the investment adviser performs a function identical to that of advisors in the art market.

2. New York State Securities Laws

Transactions in securities within New York State are regulated by the Martin Act. Commonly referred to as a “fraud act” because of its reduced emphasis on filing requirements, the purpose of the Martin Act is to defeat all “unsubstantial and visionary schemes” to fraudulently exploit the public. The state attorney general has wide discretionary powers under the Act to investigate offerings, to issue subpoenas and to seek injunctions.

127. Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(11) (1976). See generally 2 Loss, supra note 100, at 1392-1416. A fixed subscription price for uniform publications may satisfy the compensation requirement. Id. at 1410. The registration form requires information regarding the basis of the adviser’s compensation (may not be a percentage of client’s profits), his education, and business affiliations. Exemption from registration is available, where the advisory functions are strictly intrastate, confined to fewer than fifteen clients annually, and the adviser does not hold himself out to the public as an adviser (termed “shingling”). 15 U.S.C. § 80b-3(b) (1976). See also note 46 supra. A private right of action for damages suffered due to an investment adviser’s misrepresentation of material facts or other violation of the securities laws is implied under the 1940 Act. See, e.g. Agrahamson v. Fleschner, 568 F.2d 862, 872-73 (2d Cir. 1977), cert. denied, 436 U.S. 905 (1978); Sullivan v. Chase Inv. Servs., Inc., 434 F. Supp. 171 (N.D. Cal. 1977). For a circuit court decision holding that injunctive relief is also available, see Lewis v. Transamerica Corp., 575 F.2d 237 (9th Cir. 1978), modified sub. nom. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (holding that the investor may only void the advisory contract). Ahart, supra note 126, at 232-33, suggests that the distinction heretofore made between those primarily engaged in the advisory business and those not so engaged be eliminated, particularly requiring registration in those instances where the adviser has a substantial share of the market. Ahart favors reimbursement by advisers of lost profits to clients acting on investment advice. Id.


129. “New York’s Martin Act, passed in 1921, was supplemented in 1932 by very simple filing provisions. . . . But it, too, is commonly referred to as a fraud act and it falls primarily in that category.” 1 Loss, supra note 100, at 36.


132. Id. § 352(1). The Martin Act is designed to monitor traders in securities rather than to pass on the merits of the securities themselves. Thus, securities listed on exchanges located in New York are exempted from individual state registration. Id. § 359-f(1). Exemptions are available for all securities sold in a limited offer to forty or fewer persons and for other offers upon application to the attorney general. Id. §§ 359-f(2), (d). See also notes 112-14 supra and accompanying text.
3. Self-Regulation of Traders

Most writers in the securities field recognize the value of self-regulation. The provisions on registration, prevention and punishment of fraudulent practices furnish a foundation for control. However, these must be supplemented by regulation on an ethical plane. Unfair practices by the submarginal element in any industry, while technically not illegal, tend to undermine the entire market. Ethical practices within the industry must be ensured through substantial self-regulation properly supervised by government.

Provision is made in the 1934 Act for the registration, regulation and supervision of national exchanges. The exchanges must by Congressional mandate promulgate internal rules designed to prevent fraudulent and manipulative acts and to promote "just and equitable principles of trade." In compliance with this mandate, the New York Stock Exchange and the National Association of Securities Dealers maintain strict membership standards and an internal disciplinary system. Moreover, both trade organizations provide recourse to the investing public before professional arbi-

The registration requirements under the Martin Act are comparatively simple. Brokers and dealers must file a broker-dealer statement every four years. N.Y. Gen. Bus. Law § 359-e(c) (McKinney 1968). The statement contains the usual information relating to business history, criminal record and educational background. Id. § 359-e(3)(a) (McKinney 1968). It is deemed filed when received by the office of the attorney general. Id. § 359-e(9) (McKinney 1968). Investment advisers selling advisory services to more than forty persons in the state must file a yearly investment adviser statement. Id. § 359-eee(2), (3), (4) (McKinney 1968). The definition of "investment adviser" is substantially identical to that contained in the 1940 Act. Copies of prospectuses, sales literature and client solicitations intended for general distribution must also be filed. N.Y. Gen. Bus. Law § 359-eee(8) (McKinney 1968). A misdemeanor penalty is imposed for false statements of material fact contained in any filed document. Id. § 359-e(6) (McKinney 1968). Failure to file any required statement is also punishable as a misdemeanor, however, such failure does not void the transaction. See Sajor v. Ampol, Inc. 275 N.Y. 125, 9 N.E.2d 803 (1937).

133. See, e.g., 2 Loss, supra note 100, at 1361. See also Cheek, Professional Responsibility and Self-Regulation of the Securities Lawyers, 8 SEC. L. REV. 481 (1976).
134. 2 Loss, supra note 100, at 1361.
Art Purchase panels for the effective settlement of disputes. The disparate trade organizations which presently exist in the art industry, while dedicated to increasing the stature of art dealers and to encouraging ethical precepts, exercise no uniform sanctioning power over their members.138

V. Art as Security

The definition of a "security" contained in the 1933 Act includes the form of security known as an "investment contract."139 In testing for the presence of an investment contract, courts have focused on the means and terms of the transaction, rather than on the subject of the contract. For a transaction in art properties to be considered to be a security, the transaction would probably have to take the form of an investment contract.

In Securities and Exchange Commission v. Joiner Leasing Corp.,140 a leasing corporation undertook to raise the $5,000-10,000 capital necessary for an oil drilling operation141 by offering to sell surrounding land parcels to purchasers it solicited by mail.142 Purchasers were assured that the defendant would be fully responsible for developing the site.143 The advertising literature characterized the purchase as a lucrative investment and as a participation in an enterprise.144 The Supreme Court held that the offering consti-

138. See Deskbook, supra note 1, at 473-75.
139. See note 103 supra. The term has no statutory definition, but it has withstood constitutional challenge on the grounds of vagueness. See, e.g., Securities & Exchange Comm'n v. Brigadoon Scotch Distributing Co., 480 F.2d 1047, 1052 n.6 (2d Cir. 1973), cert. denied, 415 U.S. 915 (1974).
140. 320 U.S. 344 (1943).
141. Id. at 348 n.5.
142. Id. at 346.
143. Id.
144. Id. at 352-53. Some footnoted extracts from the advertising literature are of interest.

[We are submitting this proposition to you in language that will appeal to business people who are interested in making an investment where they have a good chance for splendid returns on the investment. . . . I know you would like the thrill that comes to those owning a lease around a producing well. . . . Fortunes in oil go to those who invest. We believe you should invest here and now! Id. at 346-47 n.3. The literature also contained a statement by the promoters that the securities offered were believed to be exempted from registration. The Court noted that the offerings had to be securities in order to be exempt securities. Id. See notes 111-14 supra and accompanying text for discussion of test applicable to exempted transactions. See also notes 43-45 supra and accompanying text.]
tuted an investment contract and therefore a security. In so doing, the Court pointed out that the nature of the assets supporting the investment was irrelevant. The test was "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." The Court emphasized that the securities laws were remedial and should be broadly construed to effect their underlying policy of investor protection. Thus, "it [was] not inappropriate that the promoters' offerings be judged as being what they were represented to be."

Two important factual elements led to the Court's decision. First, the defendants' prognoses of future riches for a nominal investment (twenty-five dollars or less) represented a persuasive economic inducement to invest. The sales offer was cast as a solicitation to investors, not mere purchasers. Second, the appeal of the offer was greatly enhanced by the defendants' undertaking to generate profits by drilling. The plan of distribution contemplated an apportioned share of profits to be produced by the defendants on the site through facilities and skills possessed exclusively by them.

The Joiner Court made explicit that the nature of the investment property, that is, the subject of the contract, was irrelevant. It was the manner of the offering which permitted its characterization as an investment contract. It follows from Joiner that art properties offered pursuant to an investment scheme may fall within the purview of the 1933 Act though the form of the investment is dissimilar from other more familiar securities offerings such as an oil leasehold or a share of corporate stock. The substance, not the form, of the offering is the measure of its vulnerability to securities regulation.

145. Id. at 352-53.
146. Id. at 353.
147. Id. at 348-49. Defendants were not, as a practical matter, offering naked leasehold rights.
148. Id. at 348. "[T]he undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung." Id.
149. Id. at 352-53.
150. [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or
The factors emphasized by the Court in *Joiner* were later formulated more clearly in *Securities and Exchange Commission v. Howey Co.*. In *Howey*, defendant offered unit plots of a Florida citrus grove for sale to public investors and promised substantial profits. An ancillary service contract provided for cultivation by the offeror with the net proceeds to be distributed to the individual investors. The Supreme Court recognized that the arrangement was more than an ordinary real estate sale providing for seller management. The purchase price was a capital contribution to a business venture from which the investor expected substantial returns. The Court held that the plan constituted an investment contract subject to registration. In so doing, the Supreme Court identified three essential elements inherent in every investment contract: 1) an investment of money, 2) in a common enterprise, 3) with an expectation of profits to be derived solely from the efforts of others. Relying on *Joiner*, the *Howey* Court further stated that it was immaterial whether the enterprise was speculative or nonspeculative and whether there was a sale of property with or without intrinsic value. These essential elements have been interpreted broadly by courts to effectuate the remedial purpose of the securities laws.

**A. Investment of Money**

It is not clear from *Joiner* and *Howey* whether the Court's emphasis on overtly investment-oriented advertising went to support courses of dealing which established their character in commerce as 'investment contracts' or as 'any interest or instrument commonly known as a security.'

151. 328 U.S. 293 (1946).
152. *Id.* at 295.
153. *Id.* at 300.
154. *Id.* at 301.
155. *Id.* So stating, the Court recognized that a degree of risk is inherent in every investment purchase, whether speculative (purchased for appreciation potential) or non-speculative (purchased for present value). Thus, any representations or tacit affirmations as to the current fair market value of an artwork are as critical as representations as to appreciation potential. Both kinds of purchases may fall within the purview of legislation governing investments.

The statement that there need be no distinguishing between sales property which possesses intrinsic value and property which does not is directly applicable to art properties which, by definition, intend no inherent use or value, with some quasi-functional pieces perhaps so far excepted. See *Duffy*, *supra* note 6, at 2.
the satisfaction of the element of monetary investment or of the element of profit expectation from promoter efforts. The Supreme Court's reasoning in United Housing Foundation v. Forman offers assistance in distinguishing the concepts underlying these two elements. In Forman, tenants of Co-Op City, a federally-subsidized project in New York, alleged that an increase in rental charges beyond the charges originally estimated in the offer violated the antifraud provisions of the 1934 Act. Tenants contended that the nonprofit development organization had falsely represented that it would bear any cost increases attributable to factors such as inflation. The Supreme Court was asked to decide as a threshold issue whether tenants by purchasing cooperative shares had invested money in a security. Stating that the determination of the investment element should be made in light of the economic reality and totality of the circumstances surrounding the transaction, the Supreme Court emphasized that an investor is "attracted solely by the prospects of a return on his investment." An investor must be contrasted to the purchaser who is motivated merely by a desire to use or consume the item purchased. The Court was convinced that the tenants intended to use the dwellings themselves rather than to exploit them as income-producing property. Moreover, the offer had not sought to attract investors by the prospect of profits resulting from the efforts of others, but, on the contrary had repeatedly emphasized the nonprofit nature of the endeavor.

158. Id. at 844 and 844 n.8.
159. Id. at 852. The SEC filed an amicus curiae brief urging the Court to hold that federal securities laws were applicable to the transaction. The Court refused to do so because it believed that housing cost savings and tax advantages did not satisfy the requirement of a showing that an investor have an expectation of "profits." Id. at 858 n.25. Justice Brennan, joined by Justices Douglas and White, dissented, arguing that common sense and rudimentary economics did not permit the artificial distinction to be drawn between the benefits of money saved and money earned. Id. at 863 (Brennan, J., dissenting).
160. Id. at 862-53.
161. Id. at 854.
162. Id. Decisions holding that the mere payment of a fee for counselling services does not constitute an investment contract comport with this test since in those decisions the item (services) was purchased for consumption. See, e.g., Securities & Exchange Comm'n v.
Whether an art purchaser is buying for investment or for use and consumption is difficult to determine because some element of personal appeal ordinarily accompanies the decision to purchase. However, in instances in which the art purchaser is uncertain about a piece judged from its aesthetic merit alone, often the belief that the piece represents a viable investment property will induce a purchase. The ultimate inquiry should settle on whether the purchaser seeks any measure of economic advantage in making the purchase.\textsuperscript{163} Evidence of a response to an offer framed in investment terms will reinforce any indication that the purchaser intended to purchase for investment purposes.\textsuperscript{164}

In \textit{Glen Arden Commodities, Inc. v. Constantino},\textsuperscript{168} defendants offered for resale Scotch whiskey warehouse receipts at a fixed price per gallon. Potential customers were solicited through mass merchandising techniques such as newspaper advertisements and the indiscriminate use of mailing lists.\textsuperscript{166} Prospective purchasers were promised that the whiskey purchased and remarke ted would double in value in four years and even more rapidly thereafter. The promise was a blatant misrepresentation since recent surplus

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163. Evidence of consideration given to the current holding period necessary for capital gains treatment under I.R.C. § 1221 (1978), such as an opinion of counsel that the work was a capital asset, or similar evidence, would probably be persuasive of an intent to resell. See, \textit{e.g.}, Art Appraisers of America, [1976] \textit{Fed. Sec. L. Rep.} ¶ 80,796. See also \textit{Loss}, supra note 100, at 353.

164. The Ninth Circuit has developed the "risk capital test" to determine whether the purchase was intended as an investment. Under this test there must be a commitment of assets with risk of financial loss in order to find an investment. See, \textit{e.g.}, Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976). In that case, it was enough that plaintiff was liable on a bank promissory note, having borrowed to participate in the offer, for the court to find an investment of money. See also Cordas v. Specialty Restaurants, 470 F. Supp. 780, 784 (D. Ore. 1979). Other circuits have readily found an investment of money where the purchaser has been induced by investment-oriented advertising to incur detriment for an anticipated gain. Credence is readily granted to the purchaser who reasonably approached the offer as an investment opportunity. See, \textit{e.g.}, Securities & Exchange Comm'n v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (coins purchased for later resale); Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974) (whiskey warehouse receipts for resale).

165. 493 F.2d 1027 (2d Cir. 1974).

166. \textit{Id.} at 1031.
production had severely depressed prices.\textsuperscript{167} Purchasers were assured that defendants would assist in remarketing the Scotch or buy it back themselves.\textsuperscript{168} The SEC asserted that the public offering was a security as defined by section 2 of the 1933 Act and obtained an injunction from the district court. On appeal, defendants argued that the receipts were mere commodities and petitioned for mandamus.\textsuperscript{169}

The Second Circuit upheld the district court decision, stating:

\[\text{T}here can be no question but that here the appellants were selling investment contracts. [They] guaranteed services, they promised results. \textit{The economic inducements were in the nature of inducements to invest}. \ldots \text{It ill behooves [them], after enticing their customers with fancy brochures touting their investment plan, now to claim there was no investment plan but the mere sale of an unadorned commodity.}\textsuperscript{170}

The Second Circuit emphasized the repurchase policy as a critical aspect under the terms of the investment offer. The court noted that the promised marketing assistance and repurchase, "especially in light of the absence of a market for small quantities of Scotch, [was] another distinguishing feature from the commodity analogy, one crucial to the customer's hope of liquidating his investment."\textsuperscript{171}

The investment cast of the gallery offer advertised as the "guaranteed investment collection" is self-evident. \textit{Glen-Arden} makes clear that a repurchase policy will strongly reinforce the presumption of an investment offer created by advertising content.\textsuperscript{172} The

\textsuperscript{167} \textit{Id.} at 1032. Moreover, Glen-Arden's price to its customers exceeded wholesale prices and was considerably in excess of prices charged by other brokers.

\textsuperscript{168} \textit{Id.} at 1035.

\textsuperscript{169} \textit{Id.} at 1029.

\textsuperscript{170} \textit{Id.} at 1034-35 (emphasis added).

\textsuperscript{171} \textit{Id.} at 1035. The court stated in a footnote that "\textit{[t]he Scotch whiskey investment game itself is not unknown to the SEC, and courts have uniformly found investment contracts there involved. \ldots \ldots \ldots \ldots \ldots} \textit{Id.} at 1035 n.7. In fact, in Securities Act Release No. 5018, dated November 4, 1969, the SEC issued a warning statement to sellers and distributors of whiskey that the offer of warehouse receipts constituted the offer of securities requiring compliance with the registration and antifraud provisions of the 1933 and 1934 Acts. In such instances, the investor never takes possession of the chattel, but the absence of possession is not crucial. \textit{See} note 195 \textit{infra} and accompanying text.

\textsuperscript{172} The repurchase policy featured by this form of gallery offer enhances the investment nature of the offer. Moreover, the investor's reliance on the gallery for a guaranteed resale is significant to a finding of promoter efforts to maximize profits. \textit{See} notes 212-23 \textit{infra} and accompanying text for a discussion of the SEC position on repurchase features.
distributor of original prints solicits members by offering properties explicitly stated to be "investment quality" art. In light of the Supreme Court decisions in Joiner, Howey and Forman, the economic benefit held out to the volume discount purchaser should also be recognized as an offer to invest.

B. Common Enterprise

A common enterprise has been defined as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." The necessary commonality in Glen-Arden was found in the investors' shared reliance upon the representations and services of the whiskey promoters. The element was satisfied despite the fact that any profits were to be realized from independent

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173. For a decision holding that the offer of membership in an investment club constitutes the offer of a security, see Matter of Don A. Long, [1980] FED. SEC. L. REP. (CCH) ¶ 82,624. See also 87 A.L.R. 2d 1140.

174. The print group also offers investment counsel to its membership. This feature could trigger the provisions of federal and state investment adviser regulations, although payment for advisory services alone would not constitute a security. See note 40 supra and accompanying text.

175. Besides its express rejection of each of the forms of profit found by the Court of Appeals, the Court must surprise knowledgeable economists with its proposition that profits cannot assume forms other than appreciation of capital or participation in earnings. All of the varieties of profit involved here accrue to the resident stockholders in the form of money saved rather than money earned. Not only would simple common sense teach that the two are the same, but a more sophisticated economic analysis also compels the conclusion that in a practical world there is no difference between the two forms of income. The investor finds no reason to distinguish, for example, between tax savings and after-tax income. Under a statute having as one of its 'central purposes' 'to protect investors,' it is obvious that the Court errs in distinguishing among types of economic inducements which have no bearing on the motives of investors. Construction of the statute in terms of economic reality is more faithful to its 'central purpose' 'to protect investors.' United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 863-64 (1975) (Brennan, J., dissenting) (footnotes and citation omitted) (emphasis added).

176. Securities & Exchange Comm'n v. Glen W. Turner Enterprises, 474 F.2d 476, 482 n.7 (9th Cir.), cert. denied, 414 U.S. 821 (1973). The Supreme Court in Joiner provided a colorful description of the common enterprise element, stating that the promoter's undertaking was the "thread on which everybody's beads were strung." 320 U.S. at 348. The Court also found that the sale of specific land parcels constituted an investment contract even though the definition in § 2(1) of the 1933 Act includes only fractional undivided interests. Id. at 352.

177. 493 F.2d at 1034-35.
resale of the whiskey rather than from apportioned distribution.\textsuperscript{178} In \textit{Securities \\& Exchange Commission v. Brigadoon Scotch Distributors, Ltd.},\textsuperscript{179} the court cautioned that "the common enterprise [element was not] necessarily the equivalent of the purchase of a share in a common fund."\textsuperscript{180} The requisite commonality was established when "the fortunes of all investors are inextricably tied to the efficacy of [the promoter's efforts]."\textsuperscript{181} An apportioned distribution of profits is not indispensable to the investment contract and need no longer be shown.\textsuperscript{182} The inquiry as to common enterprise has merged into an evaluation of promoter control which is often represented by the expert selection or sale of the investment property. A common enterprise is present when otherwise disparate investors are joined in purpose by the receipt of similar benefits and a shared reliance on promoter expertise to realize independent returns.\textsuperscript{183}

There are several instances of transactions in art in which the art expert undertakes responsibilities as the "thread on which everybody's beads are strung."\textsuperscript{184} For example, an exclusive dealer exerts singular control over the market for his artist's works, and purchasers of such works rely on the dealer's vigorous continued promotion of the artist. The dealer who retains on consignment a work just sold to an investor assumes full responsibility for its profitable remarketing. The special relationship which permits the volume discount dealer to market prints at essentially wholesale prices is conceptually indistinguishable from the manner of distri-

\textsuperscript{178} The suggestion from \textit{Glen-Arden} that a common enterprise was created with each investor relying independently on the promoter recalls the "rimless wheel" constellation familiar to § 1 Sherman Act litigation.


\textsuperscript{180} \textit{Id.} at 1291.

\textsuperscript{181} \textit{Id.} (quoting Securities \\& Exchange Comm'n v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974)).

\textsuperscript{182} The apportioned distribution of profits may, of course, still be present in an appropriate case. In \textit{Turner}, the district court found that the investment plan fell into all three categories enumerated in the § 2(1) definition, namely, an "investment contract," a "certificate of interest or participation in any profit-sharing agreement," and any "instrument commonly known as a security." 474 F.2d at 480.

\textsuperscript{183} \textit{See} Securities \\& Exchange Comm'n v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974), holding that the crucial inquiry was whether there was a uniformity of impact on investors of the promoter's efforts, and that separate investor returns were no bar to a finding of a common enterprise.

bution in Glen-Arden. In both instances the buyer purchases not for personal use and consumption but for profitable resale or other economic advantage. Under a membership purchase plan, independent investors are clearly identifiable as a group receiving similar benefits from and commonly relying upon a promoter to realize a profitable return.185

C. Promoter Efforts

In Securities and Exchange Commission v. Glen Turner Enterprises,186 the Ninth Circuit modified the third Howey factor to require that profits be expected not solely but only primarily from the efforts of the promoters or third persons.187 The promoters in Turner marketed self-improvement courses through purchaser recruiting efforts.188 The Ninth Circuit, noting the dubious value of the courses and the likelihood of market saturation, identified the promoters' commodity as shares in the proceeds of the selling efforts of the promoter, and thus, as an investment contract.189 The Turner Court was not deterred by the investor's own exertion to cultivate new investors. The Ninth Circuit pointed to the remedial nature of securities law and declared the new test to be "whether the efforts made by those other than the investor were the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."190

185. An Oregon court has addressed the common enterprise element, stating "In this circuit it is not required that there be a pooling of funds of all investors in order to satisfy the common enterprise requirement [citation omitted]. The commonality required is that between the investor and the promoter." Cordas v. Specialty Restaurants, Inc. 470 F. Supp. 780, 784 (D. Ore. 1979). See also Brodt v. Bache & Co., Inc., 595 F.2d 459 (9th Cir. 1978); Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976).

186. 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

187. Id. at 482.

188. The purchaser was instructed in hard-sell techniques and then rewarded with a sizeable commission for each lead he produced. Expansion of the organization by this recruitment methodology was to result in further profits to the investor in the form of shareholdings. This form of investment scheme, termed "pyramiding" has been outlawed. See Securities Act Release No. 5211 of Nov. 30, 1971.

189. 474 F.2d at 476, 478, 482. "The purchaser is sold the idea that he will get a fixed part of the proceeds of the sales. In essence, to get that share, he invests three things: his money, his efforts to find prospects and bring them to the meetings, and whatever it costs him to create an illusion of his own affluence." Id. at 482.

190. Id. "[The selling efforts of the promoter] are the sine qua non of the scheme; those efforts are what keeps it going; those efforts are what produces the money which is to make him rich. In essence, it is the right to share in the proceeds of those efforts that he buys."
Several decisions since *Turner* have recognized that the promoter need not apply "managerial" efforts. Frequently it is the promoter's market expertise which constitutes the efforts upon which the investor relies. In *Glen-Arden*, the investor was dependent upon the promoters to utilize their expertise in selecting the type and quality of Scotch whiskey and casks to be purchased for resale by the investors in an enterprise virtually guaranteed to "double their money" in four years. Emphasizing the investor's reliance on the promoter's expertise, the Second Circuit stated, "[t]here have been many other schemes . . . where the public was led into buying what purported to be tangible items when in fact what was being sold was an investment entrusting the promoters with both the work and the expertise to make the tangible investment pay off." It was clear that the investors in *Glen-Arden* would not have entered the market but for their explicit reliance on the promoter's promise of expert assistance in selecting and marketing the investment property.

In *Securities and Exchange Commission v. Brigadoon Scotch Distributors, Ltd.*, promoters expertly compiled and sold rare

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*Id.* The case has been widely approved, Annot., 54 A.L.R.3d. 217, 239-41 (1973). The outer limit of the test may have been reached in *Coffin v. Tricoli*, 470 F. Supp. 7 (E.D. Va. 1977), *rev'd. sub. nom.* *Coffin v. Polishing Machines, Inc.* 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), wherein a 50% purchaser was found to have "bought himself a job with the company." *Id.* at 11. The court stated "[a]n investor who also becomes a part of management should not be able to claim the protection of the Act merely because others in the common enterprise exert essential managerial efforts which affect the failure or success of the enterprise." *Id.* For a New York decision following *Turner*, see Securities & Exchange Comm'n v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976), *aff'd*, 556 F.2d 559 (2d Cir. 1977).

191. 493 F.2d 1027 (2d Cir. 1974).

192. *Id.* at 1035 (emphasis in original). *See also* Securities & Exchange Comm'n v. Paro, 468 F. Supp. 635 (N.D.N.Y. 1979). Defendant in that case solicited investors for its "co-op advertising" publication. The investor was "assigned" a product, with the promoter handling all elements of publication and processing of orders for the unfamiliar product. The investor was assured a small fortune for trusting to the promoter's "brilliant advertising skills" the development of a market for the product. The investor never saw any part of the operation save his proportionate share of the proceeds. *Id.* at 639-41.

193. 493 F.2d at 1032. Later, citing *Forman*, the court stated, "[i]n light of the economic reality and the totality of circumstances surrounding the sales here, the customers were making an investment, which in view of the appellant's commitments and representations constituted an 'investment contract' within the meaning of § 2(1) of the Securities Act." *Id.* at 1034.

coin portfolios. While the investors in *Glen Arden* were enticed by promises of discount prices and consequent resale profits, *Brigadoon* marketed its coin collections expressly with a view to appreciation value. The court focused on the promoters' offer of purported expertise to the investor by pointing out that *Brigadoon* advertised to a general readership rather than in collectors' trade publications. Specifically addressing itself to the *Howey* "efforts" element, the court stated that "[t]he representations made in the advertisement pamphlet present a package of expert skills deliverable to any FCR customer and offered to maximize the capital of FCR investors." The promoters' application of selective expertise went into the investment package as "the most crucial factor in determining how much profit an investor in coins would make." It was clear that the investors relied on the promoters' representations of appreciation potential and that each coin's present value was a direct correlative of that potential.

In *Matter of Gardner v. Lefkowitz*, petitioner contested the application of New York's Martin Act to its offer for sale to the public of diamonds, arguing that the sale was no more than a simple exchange of personalty for a purchase price. It urged that the basic nature of the transaction was not altered by the fact that a

195. The Second Circuit declined to distinguish these decisions on the fact alone that *Brigadoon* investors acquired custody of their coins, holding that "possession per se [did not reconvert] an investment contract to the sale of a commodity." *Id.* at 1293.

196. *Id.* at 1291.

197. *Id.* at 1292.

198. *Id.* at 1292-93.

199. The Second Circuit stated that, "[c]omparisons of gains in the stock market with returns from coins, analysis of coin appreciation and similar investment information [ran] in a constant and main stream throughout FCR's sales pitch." *Id.* at 1291. Thus, the original language from *Howey* requiring an expectation of "profits" is broad enough to include earned or distributed profits and appreciation gains, that is, capital gains on resales or tax deductions on donations. *See also* Aldrich v. McCulloch Properties, Inc., [1980] FED. SEC. L. REP. (CCH) ¶ 97,600. "That the plaintiffs did not expect to realize any tangible gain until they sold their property does not preclude investment intent." *Id.* ¶ 98,179.

200. 97 Misc. 2d 806, 412 N.Y.S.2d 740 (Sup. Ct., 1978)

201. N.Y. GEN. BUS. LAW § 352 (McKinney 1968). The immediate threat to Gardner posed by an adverse decision was an investigation into its business operations by the state attorney general. In this regard the court stated that "one of the reasons for [the investigation] is to adequately develop a factual basis for a determination by the Attorney General as to whether or not the object being investigated comes within the scope of his authority under the Martin Act." 97 Misc. 2d at 812, 412 N.Y.S.2d at 745.
diamond may often have value as an investment.\footnote{202}

After analyzing petitioner's sales methods,\footnote{203} and noting the overt investment orientation of petitioner's advertising, the \textit{Gardner} court concluded that the diamonds were meant as investment purchases. They were described to the public as an investment and that was the thrust of the purchase.\footnote{204} Pointing to the significance granted by \textit{Joiner} and \textit{Howey} to the promoter's manner of presentation, the \textit{Gardner} court held petitioner to its own advertising representations, and ruled that "petitioners [had been] emphatically entrusted with the work and [diamond] expertise of producing a payoff."\footnote{205}

A promoter offering an investment-type property with some provision made for maximizing the investor's capital will be deemed to be offering a security.\footnote{206} A promoter maximizes profits through the offer of expert advice or the selection of the investment property preceding the sale.\footnote{207} Unfortunately, the public policy statements

\footnote{202. \textit{Id.} at 812, 412 N.Y.S.2d at 746. The purchaser was permitted to return any item within five days of delivery. \textit{Id.} at 807, 412 N.Y.S.2d at 742. As a further distinction, petitioner argued that no instrument had been delivered to the purchaser, only the sales item itself. \textit{Id.} at 812, 412 N.Y.S.2d at 745. The absence of an instrument is irrelevant.}

\footnote{203. Petitioner employed both commercial advertisements and random telephone canvasses followed up by dissemination of a descriptive brochure. \textit{Id.} at 814, 412 N.Y.S.2d at 746-47.}

\footnote{204. \textit{Id.} at 813, 412 N.Y.S.2d at 746.}

\footnote{205. \textit{Id.} at 815, 412 N.Y.S.2d at 747.}

\footnote{206. A frequent claim is made that because diamonds, art and other properties bought outright are traded on a fluctuating market, there can be no satisfaction of the third \textit{Howey} element. See, e.g., \textit{Art Appraisers of America}, supra note 43, ¶ 87,081. The \textit{Turner} court cautioned that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities." 474 F.2d at 482. Inherent in the analysis is the self-evident understanding that market fluctuations are seldom within the control of anyone. The argument that returns are the product of sheer chance fails completely with the introduction of an exclusive dealer or distributor whose very attraction to clients lies in his enhanced influence on the market. See note 18 supra.}

\footnote{207. In \textit{Securities \\& Exchange Comm'n v. Energy Group of America, Inc.}, 459 F. Supp. 1234 (S.D.N.Y. 1978), the decisions just discussed were categorized either as cases where investors contributed capital to an enterprise expecting a participation in earnings resulting from the use of their funds, or as cases where tangible or intangible property was purchased by the investor in the expectation that it would appreciate in value, either because of the promoter's expertise in selecting the property or because of the promoter's managerial or entrepreneurial efforts subsequent to the purchase of the property.}
issued by the SEC do not yet reflect the importance of presale maximization efforts.

VI. Current SEC Position

A review of recent "no action" letter requests\(^2\) isolates three "swing factors" which are afforded considerable weight by the SEC when testing for the presence of an investment contract which would be subject to section five registration.\(^2\) These factors are: 1) resale services or marketing assistance; 2) installment sales; and 3) repurchase features.\(^2\) Any one or a combination of these factors will likely be present in a typical art transaction.

A. Resale Services

In *Glen Arden*, the Second Circuit noted that the requisite promoter efforts were satisfied by the offer to assist investors in remarketing their whiskey. For that purpose investors were provided with a list of potential buyers.\(^2\) It is the position of the SEC that assistance may be indirectly provided.

Recently, Photographic Artists, Ltd. ("PAL"), requested a no action letter from the SEC regarding PAL's proposed sale of original photographic transparencies to individual purchasers.\(^2\) PAL offered investors a standard form agreement which provided for the production and marketing of the transparencies as prints by an unaffiliated company.\(^2\) The SEC expressed the view that this sales

\(^{208}\) See note 107 supra.


\(^{210}\) See Boston Advisory Group, SEC Staff Reply Letter of Dec. 5, 1976. Although already registered as investment advisers, the Boston Advisory Group was cautioned that its proposed diamond offering might also require registration as a broker.

\(^{211}\) See also [1976] Fed. Sec. L. Rep. (CCH) ¶ 87,079; Art Appraisers of America, Ltd., SEC Staff Reply Letter of Sept. 3, 1976 (available October 4, 1976). Art Appraisers provided its purchasers with a list of charitable organizations willing to accept donations of the prints sold in volume discount. Inasmuch as this service assists purchasers in liquidating their investments, it is indistinguishable from the promoter assistance in *Glen-Arden*. The SEC stated to Art Appraisers that it would not recommend enforcement action, apparently because most purchasers were motivated by anticipated tax benefits, although others intended resale. The economic advantage held out to the volume discount purchaser, even in the form of a tax write-off, could be better viewed as constituting an investment of money. See note 168 supra. Moreover, it is clear that purchasers did not buy the print packages for use or consumption. See United Hous. Foundation v. Forman, 421 U.S. 873 (1975).


\(^{213}\) This unaffiliated company was also to handle the advertisement for the prints.
method might involve the offering of a registrable security and stressed the pre-negotiated production and marketing agreement offered by PAL.  

The offer by Metropolitan Graphic Art Distributors, Inc. ("MGA"), provides an example of resale services which may accompany the distribution of original prints. MGA acquired entire editions of each work directly from the artist and thus acted as exclusive distributor for each work. It proposed to make daily value quotations available to the purchasers and to otherwise assist them in finding a market for the prints. Responding to the no action letter request, the SEC cautioned that the offer probably constituted the offer of a security subject to registration. In so concluding, the SEC emphasized the provision by MGA of resale services and its publication of daily value quotations.

B. Installment Sales

Frequently the method by which payment is made for art properties will create a relation between the parties which continues beyond the date of purchase. The use of installment payment plans by many galleries and the similarity of such plans in some cases to margin accounts has been pointed out. The likelihood that an installment payment plan will be offered is naturally greatest when the investment property purchased is an expensive piece of art.

The SEC refused a no action letter request relating to the sale of lithographic plates by Creative Art Industries. The offer proposed to furnish each purchaser with quotations from four distributors capable of reproducing and marketing the reproductions nationally. In addition to these resale services, the sales plan

214. The SEC stated further that the offering was not eligible for exemption under Rule 146 and found an integration. See notes 111-14 supra (discussing exemption and the factors examined in testing for integration).


216. MGA also offered a repurchase policy, discussed at notes 223-24 infra and accompanying text.

217. See notes 17-18 supra and accompanying text.

provided for payment in part from a percentage of the purchaser's gross sales of reproductions from the plate over a nine-year period.\footnote{219}

C. The Repurchase Feature

The Heritage Bookshop requested a no action letter from the SEC concerning a proposal to offer a "Rare Book Investment Portfolio" by membership subscription.\footnote{220} The offer featured a repurchase option periodically exercisable by the purchaser at fixed increasing rates of return.\footnote{221} Alternatively, the purchaser could consign books back to the seller for resale.\footnote{222} The SEC expressed the view that the offer constituted an investment contract subject to section five registration. In so doing, the SEC emphasized the guaranty arrangements featured by the offer.

The no action letter request from MGA also included a simple offer to repurchase any print at the prevailing market rates indicated by its daily value quotations. The terms of such an offer, while not guarantying any profit, nevertheless assure the purchaser of a resale at any time.\footnote{223} The SEC rejected the request, stating that the presence of the repurchase feature presented a serious question of vulnerability to section five registration.\footnote{224}

\footnote{219.} Payment to the print distributor by this method may provide incentive to the purchaser to market its reproductions, while creating the inextricable tie to the promoter described in Securities & Exchange Comm'n v. Koscot Interplanetary, Inc., 497 F.2d at 479.

\footnote{220.} See Heritage Bookshop, SEC Staff Reply Letter of Mar. 13, 1979. This offer by membership subscription is similar to that made by the print distributor discussed at notes 35-42 supra. For a decision holding that the offer of membership in an investment club constituted the offer of a security, see Matter of Don A. Long, [1980] Fed. Sec. L. Rep. (CCH) ¶ 82,624.

\footnote{221.} See notes 27-34 supra and accompanying text.

\footnote{222.} See note 26 supra and accompanying text.

\footnote{223.} The SEC has rejected the argument that a 10\% guaranteed profit is "too low to induce a person to buy." See Longines Symphonette Society, SEC Staff Reply Letter of Nov. 10, 1972, (available Dec. 11, 1972), [1972-1973] Fed. Sec. L. Rep. (CCH) ¶ 79,151. See also Department of Commerce v. DeBeers Diamond Inv., Ltd., 89 Mich. App. 406, 280 N.W.2d 547 (Ct. App. 1979), for a decision holding that the offer to buy back any diamond purchased at the current prevailing market price was insufficient to constitute a security. The merchants in DeBeers warranted that the offering cost to investors would be at least 75\% below fair market value. However, investors discovered when they sought to exercise the repurchase option that the promoters were unwilling to pay the prevailing market price, offering to buy back only at their own current discount rate.

\footnote{224.} It is conceivable that a seller's offer to refund the buyer's purchase price could constitute a repurchase policy if the option is kept open for a considerable length of time.
VII. Conclusion

The reach of the securities law has consistently widened through the implementation by the SEC and the courts of its broad policy of investor protection whenever appropriate. Courts have followed the Supreme Court’s reasoning in Joiner and Howey that the nature of the investment property is irrelevant if the substance of an investment contract is present. The attitude, frequently unarticulated but persistent, that art works are exchanged in a rarefied context of reverential appreciation for their intrinsic aesthetic merit may perpetuate reluctance to regulate the art market. Yet, art is an investment property which is traded by businessmen in a brisk and economically broad-based market. Recognition that the substance of an art transaction constitutes an investment contract or other form of security should trigger familiar investor protections.

Significant investor reliance is placed on the art merchant to maximize profits through his expert selection, compilation, recommendations or representations preceding or attending the art purchase. Such reliance is reinforced by the offer of services subsequent to sale such as a repurchase policy, installment plan or marketing assistance. The assertion that profits on a fluctuating art market are the uncontrollable product of chance and thus not the province of the art merchant is without merit. In those instances in which the dealer-client relationship threatens confusion resembling that between broker-dealers and their customers, a similar bar against overreaching and liability for unwarranted recommendations should be imposed. Art advisers or others who provide investment counsel should be subjected to applicable state or federal investment adviser regulations.

Any burden imposed on the art community by the registration and antifraud strictures of federal and state securities law is outweighed by the benefit to the public of the preventive and remedial protections afforded by their application. In appropriate in-

225. The filing procedures under the Martin Act relevant to dealers and advisors active within New York State could be simply complied with and would help ensure that such persons are qualified and reputable. The broad discretion accorded the attorney general under the Martin Act to investigate unfair trade practices and to ascertain during the process whether a security is present facilitates local elimination of impediments to the art market in New York.
stances, federal and state antifraud provisions will improve the opportunity for effective investor redress now severely hampered by the prevailing doctrine of *caveat emptor* and the high thresholds required to establish proof of common law fraud. Registration provides useful investment information, with care taken to exempt only those offers to persons able to fend for themselves.

Effective self-regulatory measures similar in impact to those followed in the securities market might be implemented by the art dealing community.\(^{226}\) A central governing association with strict certification or membership criteria and sanctioning power could do much to increase public confidence. Recourse before an expert arbitration panel with members rule-bound to arbitrate customer disputes would enhance market relations and reduce costly litigation.

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\(^{226}\) The harsher alternative, of course, would be state licensing or certification of art merchants.