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FINANCE NOUVEAU: PROSPECTS FOR THE SECURITIZATION OF ART

JACLYN MCLEAN*

I. INTRODUCTION

A $33.6 million Matisse, a $27.5 million Picasso, and a $100 million diamond skull. As artwork becomes increasingly more valuable, art buyers will search for creative ways to finance their acquisitions. Attention has been drawn recently to the world of art because of record auction prices. However, there is also an excellent track record for returns on artwork, and it plays an important role in creating a diverse investment portfolio. The emergence of art as an investment class has led to the creation of art investment firms, funds, and financial advisors. As more and more people recognize the potential in art investments, the next step in art investing may just be securitization. This Note explores whether or not the securitization of artwork can be used as a practical tool to raise funds to purchase art and in turn provide investment income. If art collectors and other investors view artwork as a separate asset class for financial investment, an asset-backed securitization scheme would provide a means of raising capital and receiving returns on their investments. It would also open up the world of art investing to people who may never have thought it possible, but have always wanted to own a Rembrandt, even if just a fractional interest.

This article begins with a short overview of Asset-Backed Securitizations (ABS) in Part II. This overview focuses on basic structures, risks, and tax issues associated with ABS. Over the past twenty years the ABS market has grown steadily. The growth in the ABS market has led many companies, and even some individuals, to issue securities backed by more exotic receivables and cash-producing assets such as: taxicab medallions, pharmaceutical prescriptions, income expected from federal highway grants, and music royalties. However, for the year 2007, the ABS market was down twenty-six percent from 2006. This decline is due in large part to the subprime mortgage crisis's effect on real estate securitizations and a collapse in Collateralized Debt Obligations (CDOs). The plunge in the ABS market was the

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2. "Artwork" is defined for the purposes of this article as any type of fine art, including paintings, sculpture, music, and photography.


5. See infra Part III.A. (discussing "Bowie Bonds").


7. THOMPSON FINANCIAL, supra note 4, at 1.

8. Id. at 8. The subprime mortgage crisis occurred when more borrowers than expected defaulted on their adjustable-rate mortgages (ARM) as a result of home prices dropping and ARM interest rates significantly increasing. Steven L. Schwarz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown 6 (Duke Law School Legal Studies Paper No. 175), available at http://ssrn.com/abstract=1056241 [hereinafter Protecting Financial Markets]. This caused "collections on subprime mortgages to plummet below the original
first decline in the United States market in over twenty years. The international market fared better than the U.S. ABS market, with a slight decrease of 1.6 percent compared to proceeds in 2006.10

Part II.A focuses on the reasons why people invest in ABS, with an emphasis on benefits and risks for the parties involved in the transaction. Part II.B then discusses the anatomy of an Asset-Backed Security, followed by Part II.C’s look at bankruptcy remoteness and the true sale aspect of the securitization transaction. This section ends with an overview of the tax treatment of ABS in Part III. The article then moves to securitizing assets with copyrights in Part II.D, and the specific example of Bowie Bonds. Bowie Bonds and securitizations backed by copyrightable assets provide good examples of how a potential art-backed securitization could be structured, and many of the potential obstacles that could present problems for an art-backed securitization. After that discussion, the Article moves to its primary focus, the securitization of artwork. This section begins with Part IV.A, the emergence of art as an investment class. Part IV.B presents potential approaches to structuring the securitization, including a discussion of the different players involved in an art-backed securitization such as the originator, collateral manager, trustee, and servicer. Finally, Parts IV.C and D focus on the benefits, risks, and obstacles of securitizing artwork. Securitizing artwork appears to be the next logical addition to the world of art financing. However, there are many obstacles to be overcome, including the volatility and unpredictable income streams of artwork, transaction costs, and numerous copyright impediments.

II. BACKGROUND ON ASSET-BACKED SECURITIES

A. Why Securitization?

Asset securitization has been one of the primary means of capital formation in the United States for years.11 An “Asset-Backed Securitization”12 is the sale of a
debt or equity instrument that represents an ownership interest in an income-producing asset or pool of assets. The assets in a securitization are segregated in order to reduce and reallocate risks inherent in owning a particular type of asset. Furthermore, by lowering the risk of ownership, the interests become more marketable and therefore more liquid. Many different types of assets can be securitized—for example, credit-card receivables, auto loans, franchise fees, health care receivables, and future media revenues.

Securitization can provide both originators and investors with many benefits. One very attractive aspect of securitization is that it provides originators with off-balance sheet funding. However, securitization is most valuable when “the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the Special Purpose Vehicle’s (“SPV”) securities, is less than the cost of the originator’s other, direct sources of funding.” The interest rates are generally determined by rating agencies that rate the SPV’s securities. An interesting aspect of the rating system is that the securities, and not the company issuing them, are being rated. That is, the rating agencies analyze the strength of the assets underlying the securities and not the status of the issuer. Therefore, an originator who may not be able to issue securities with a high credit rating can create an SPV designed to assure the servicing or timely distributions of proceeds to the security holders.”

13. STRUCTURED FINANCE, supra note 11, § 1:1.
14. Id.
15. Id. Liquid assets are assets that are capable of being bought and sold “in a short period of time with relatively small price changes engendered by the transaction.” DAVID L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY’S INVESTOR 212 (3d ed. 2003).
17. Fairfax, supra note 6, at 450; STRUCTURED FINANCE, supra note 11, § 1:2. Other examples of receivables that have been securitized include commercial loans, student loans, boat loans, nursing home receivables, and airline ticket receivables. Hill, supra note 16, at 1076–77.
18. An originator is a company or individual who sells its rights to receive future payments, receivables, or income producing assets to a separate entity.
19. Steven L. Schwarz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 143 (1994). This means that the originator does not have to record the transaction as a liability on its balance sheet, due to the fact that the originator’s transfer of assets to the SPV is treated as a sale and not a financing. Id. Liabilities are obligations to pay another party. SCOTT, supra note 15, at 209.
20. The SPV is a separate entity to which the receivables or income producing assets are assigned. The SPV will be discussed in detail at infra Part II.B.
21. STRUCTURED FINANCE, supra note 11, § 1:3. One of the main goals an originator has when structuring a securitization is “to design a product that can find investors and still generate a positive economic return.” STANDARD & POOR’S STRUCTURED FINANCE COMMENTARY: THE FUNDAMENTALS OF STRUCTURED FINANCE RATINGS 3 (2007), available at http://www2.standardpoors.com/spf/pdf/media/082307_ian_op_ed_brt.pdf [hereinafter STRUCTURED FINANCE COMMENTARY].
22. STRUCTURED FINANCE, supra note 11, § 1:3.
23. Schwarz, supra note 19, at 141.
24. Id.
25. Credit ratings are “formal evaluation[s] of the credit quality of a bond.” Securitization Glossary, supra note 8, at 441. There are three rating agencies that issue ratings for bonds: Moody’s, Standard & Poor’s, and Fitch. The agencies use symbols like “AAA” to express the quality of the bond. Id. According to a Standard & Poor’s publication, their ratings are opinions “on the default risk associated with either an issuer or an issue...based on all the information [they] have in [their] possession. [Their] rating speaks to the likelihood of default, but not the amount that may be recovered in a post-default scenario.” STRUCTURED FINANCE COMMENTARY, supra note 21, at 9.
that issues securities with investment grade ratings\textsuperscript{26} to obtain funding.\textsuperscript{27} Generally, the higher the security's rating, the lower the company's cost of funds.\textsuperscript{28} This is because securities with higher ratings can issue debt securities with lower interest rates as a result of their high likelihood of repayment.\textsuperscript{29} 

Securitization is very attractive to many companies in search of financing because "securitization increases the liquidity of a company by enabling it to access future income immediately."\textsuperscript{30} Securitizing assets converts their future incoming payments into instant cash.\textsuperscript{31} This is particularly beneficial to companies wishing to accumulate "generalized purchasing power" or engage in long-term investments.\textsuperscript{32} Additionally, securitization diversifies financing options available to companies unable to access the capital markets.\textsuperscript{33} Finally, as discussed above, securitizing assets allows originators to obtain off-balance sheet funding since the transaction is not treated as a liability, but as a sale.\textsuperscript{34}

Securitization also provides opportunities for investors. ABS investments are considered important tools for proper portfolio management.\textsuperscript{35} Asset-backed securitizations are generally less volatile than corporate bonds, and are not as vulnerable to possible future negative ratings of the originator.\textsuperscript{36} It also allows buyers to tailor their investment profiles based on their risk preferences.\textsuperscript{37} Investors are able to compare risks based on rating agencies' objective and independent risk assessments of securities.\textsuperscript{38} Investors are then able to identify securitizations with the credit risk they are looking for and invest accordingly.\textsuperscript{39}

One of the main ways an issuer tailors securitizations to meet the risk preferences of investors is through tranching.\textsuperscript{40} Tranches, or classes, of securities are typically ranked by priority of payment, with the highest priority class receiving payment

\textsuperscript{26} Investment grade ratings are bonds that have been given ratings of BBB and above by rating agencies. SCOTT, supra note 15, at 198.
\textsuperscript{27} STRUCTURED FINANCE, supra note 11, § 1:3.
\textsuperscript{28} Id.
\textsuperscript{29} Id.
\textsuperscript{30} Fairfax, supra note 6, at 451–52. Liquidity means that an entity has cash or other assets that are easily converted into cash. SCOTT, supra note 15, at 213.
\textsuperscript{32} Id. at 610.
\textsuperscript{33} Fairfax, supra note 6, at 452. The capital market is the market where securities, like common stock and bonds, are traded. SCOTT, supra note 15, at 51.
\textsuperscript{34} Schwarcz, supra note 19, at 143.
\textsuperscript{36} See generally Astrid Van Landschoot & William Perraudin, How Risky are Structured Exposures Compared with Corporate Bonds?, available at http://www.bis.org/publ/cgfs23perraudin.pdf.
\textsuperscript{37} STRUCTURED FINANCE COMMENTARY, supra note 21, at 3.
\textsuperscript{38} Id.
\textsuperscript{39} Id. Investors may want to invest in a riskier security because oftentimes securities with the greatest amount of risk yield the greatest rewards. The riskier securities issued by an SPV will usually have a high interest rate, paired with a low likelihood of repayment. If the SPV does repay investors, they have a good chance of making a substantial return. See infra notes 40–49 and accompanying text.
\textsuperscript{40} "Tranching is the process by which securitisation issues are structured, by creating different risk, duration or other characteristics backed by the same pool of assets." Maciej Firla-Cuchra & Tim Jenkinson, Security Design in the Real World: Why are Securitization Issues Tranches? At 32 (EFA 2005 Moscow Meetings Paper), available at http://ssrn.com/abstract=676730 [hereinafter Security Design].
first, and lower, or subordinated classes, receiving payment once all the higher priority classes are paid.\textsuperscript{41} The use and extent of tranching varies according to the SPV's underlying assets.\textsuperscript{42} Interestingly, there appears to be a relationship between the number of tranches and the overall size of the SPV's issue.\textsuperscript{43} "Issues over $1 billion in size have, on average, over 5 tranches, issues of $100 million or less have barely 2 tranches...[and] there is a significantly greater number of single-tranch issues among very small transactions."\textsuperscript{44} Generally, investors looking for a stable investment would invest in the most senior and highest rated of a securitization's tranches.\textsuperscript{45} Due to the over-collateralization\textsuperscript{46} or credit enhancement\textsuperscript{47} of this tranch, it has the highest predictability of repayment.\textsuperscript{48} A more sophisticated investor with more information about the underlying assets may be more willing to invest in a junior tranch.\textsuperscript{49} Overall, by tranching the structure of the securitization the issuer presents the investor with a choice as to the amount of risk he is willing to take in investing.

For all the benefits of securitization there are also a number of risks associated with this type of transaction. The SPV's main risks are twofold: delay in payment and default in payment.\textsuperscript{50} These risks are related to the assets pooled together in the SPV.\textsuperscript{51} An SPV issuing securities backed by receivables with a high predictability of repayment should not be concerned with the risks of delay or default in payment.\textsuperscript{52} However, receivables with an uncertain or perhaps untested payment stream will place an SPV at greater risk.\textsuperscript{53}

Third-party credit enhancement can be used to compensate for the risks associated with repayment.\textsuperscript{54} Credit enhancement occurs when a third party with a high rating assumes a portion of the risk of nonpayment.\textsuperscript{55} The third party will generally issue a financial guaranty in support of the securities, thus allowing the securities to achieve a high rating.\textsuperscript{56} By enhancing their credit rating, an SPV can

\begin{itemize}
  \item \textsuperscript{41} Protecting Financial Markets, supra note 8, at 5–6. This is generally called the “waterfall” of payment. \textit{Id.} at 6. The senior classes have a greater predictability of payment to investors than the subordinate classes due to the fact that “the senior classes are highly overcollateralized to take into account the possibility, indeed likelihood, of delays and losses on collection” of the underlying assets' revenue. \textit{Id.}
  \item \textsuperscript{42} Security Design, supra note 40, at 2.
  \item \textsuperscript{43} \textit{Id.} at 9.
  \item \textsuperscript{44} \textit{Id.}
  \item \textsuperscript{45} \textit{Id.} at 8 (“tranching is often said to be about carving out a riskless tranch”).
  \item \textsuperscript{46} Overcollateralization ensures that the “par amount of securities issued in a deal is less than the aggregate principal amount of underlying financial assets being securitized.” \textit{Securitization Glossary}, supra note 9, at 441. For example, a $20 issuance of securities would actually be backed for $30 worth of assets. \textit{Id.} at 446.
  \item \textsuperscript{47} “Credit enhancement” refers to third-party credit enhancement which occurs when a third party with a high credit rating assumes a portion of the risk of repayment. \textit{Structured Finance}, supra note 11, § 2:3.
  \item \textsuperscript{48} See \textit{Structured Finance}, supra note 11, § 2:3; infra note 54 and accompanying text.
  \item \textsuperscript{49} Security Design, supra note 40, at 3 (arguing that investors' ability to “screen investments” influences their affinity for one tranch over another).
  \item \textsuperscript{50} \textit{Structured Finance}, supra note 11, § 2:1:1.
  \item \textsuperscript{51} Fairfax, supra note 6, at 457.
  \item \textsuperscript{52} \textit{Id.}
  \item \textsuperscript{53} See \textit{id.}
  \item \textsuperscript{54} \textit{Structured Finance}, supra note 11, § 2:3. In addition to third-party credit enhancement, issuers may turn to overcollateralization to improve the credit quality of their bonds. See supra note 46 and accompanying text.
  \item \textsuperscript{55} \textit{Structured Finance}, supra note 11, § 2:3.
  \item \textsuperscript{56} \textit{Id.} Forms of third-party credit enhancement include surety bonds, letters of credit, cash collateral accounts, or insurance. Robert Dean Ellis, \textit{Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights}, 24 J. CORP. L. 295, 302 (1999).
reap the benefits of issuing securities at a lower interest rate, thus lowering the cost of raising capital.\textsuperscript{57} This practice is especially common when “the receivables are novel or do not have an established record of payment.”\textsuperscript{58}

An originator considering securitization must consider the costs of setting up the transaction. In particular, an originator should compare “the expected differential between interest payable on nonsecuritized financing and interest payable on securities issued by an applicable SPV with...the expected difference in transaction costs between the alternative funding options.”\textsuperscript{59} The costs attributable to nonsecuritized financing include loan fees and the interest payments on that loan, among others. Costs attributable to a securitization include investment banking fees, legal fees, and the interest payable on the securities, among others. Therefore, it is crucial for parties wishing to set up a securitization to do their due diligence before entering into a costly and unprofitable transaction. Essentially, it is only economical for an originator to set up a securitization if the costs are less than what the cost would be to obtain nonsecuritized financing.\textsuperscript{60}

\textbf{B. Anatomy of an Asset-Backed Security}

The structure of a securitization helps to mitigate risks associated with securitizing assets. In a traditional asset-backed securitization, the originator sells its rights to receive future payments, receivables, or income producing assets to a separate entity. The receivables are pooled together in the separate entity, the SPV.\textsuperscript{61} The SPV then sells those rights to future payments in the form of securities.\textsuperscript{62} An SPV’s receivables are generally heterogeneous assets with similar characteristics.\textsuperscript{63} As mentioned above, there are many different types of assets and receivables that can be used in asset-backed securities.\textsuperscript{64} The common thread in each of these receivables is a predictable payment stream, which is one of the most important elements of a successful securitization.\textsuperscript{65}

The SPV is a distinct entity, separate from the originator, so that the risks inherent in the originator do not affect the receivables.\textsuperscript{66} An SPV generally issues securities in the form of debt or equity instruments.\textsuperscript{67} The type of securities the SPV issues generally dictates whether the SPV will be structured as a pay-through or

\textsuperscript{57} STRUCTURED FINANCE, supra note 11, § 2:3.

\textsuperscript{58} Id.

\textsuperscript{59} STRUCTURED FINANCE, supra note 11, § 1:3.

\textsuperscript{60} Id.

\textsuperscript{61} Id. § 1:2.

\textsuperscript{62} Fairfax, supra note 6, at 445. The predictable payment stream of receivables will prove to be one of the central problems for art securitization. \textit{See infra} Part IV.D.

\textsuperscript{63} Hill, supra note 16, at 1067.

\textsuperscript{64} Supra note 6 and accompanying text.

\textsuperscript{65} STRUCTURED FINANCE, supra note 11, § 2:1.

\textsuperscript{66} See id.

\textsuperscript{67} Fairfax, supra note 6, at 446. The two main types of securities issued by SPVs are debt and equity securities. Debt securities represent borrowed funds from investors that are repaid over a set period of time. SCOTT, supra note 15, at 97. “Examples of debt securities include bonds, certificates of deposit, commercial paper, and debentures.” Id. Equity securities are stock. Id. at 127. Stock is an ownership share in a company, and in this case, the assets backing the securities. Id. at 359.
pass-through vehicle. A pay-through vehicle issues debt instruments and allows security holders to receive fixed payments that are secured by the receivables and based on anticipated cash flow. On the other hand, an SPV that issues equity securities is a "pass-through" vehicle. Pass-through vehicles disperse payments proportionally to the security holders based on the receivables' cash flow and their ownership share.

Another consideration originators may have when transferring the receivables to the SPV is whether a servicer and trustee should oversee the receivables. A servicer manages the SPV's assets in an asset-backed securitization. Servicers are responsible for collecting revenues brought in by the assets and enforcing rights that may be unique to the assets. Servicers also report to the investors on how the assets are performing. That information is then used to determine how distributions will be made to the security holders. Oftentimes the servicer is the original seller of the assets. However, in order to maintain the integrity and independence of the servicer, it is advisable to have third-party oversight. This can be done with the appointment of a trustee "to administer the operation of the securitization and to serve as the representative of the investors." Trustee duties also include enforcing remedies for security holders in the event of default, making interest payment on the securities, and "investing idle cash assets." With the appointment of both a servicer and a trustee, investors can feel more assured that their investments are being managed carefully by the SPV.

C. Bankruptcy Remoteness and the True Sale

1. Bankruptcy Remoteness

Successful securitizations minimize risks related to bankruptcy and "unexpected liabilities." Transferring receivables to a bankruptcy remote SPV is essential in accomplishing this. Ensuring that the assets are bankruptcy remote greatly reduces the possibility that a court will subject the securitized assets to bankruptcy claims.

68. Fairfax, supra note 6, at 446.
69. Id.
70. Id.
71. Id.
73. Id.
74. Id.
75. Id. at 396.
76. Id. at 389–90.
77. Id. at 389.
78. Id.
79. Fairfax, supra note 6, at 456. These unexpected liabilities stem from assets or risks associated with the originator. Investors are not "subject to the vagaries of the originator’s business behavior, and their risk exposure is limited to the obvious risk associated with the assets in the pool.” Id. at 457. Essentially, investors should not be victim to an originator's unexpected troubles.
80. Bankruptcy remoteness is a technique "used for isolating assets or loans from the bankruptcy risk of the company financing or selling them.” Securitization Glossary, supra note 8, at 438. The bankruptcy remote structure of a securitization is one of the main distinguishing factors between a securitization and secured financing. Id.
81. Fairfax, supra note 6, at 456.
of the originator's creditors. To make certain that the SPV is bankruptcy remote, the parties structure a "true sale" of the receivables or financial assets to the SPV. This true sale places the assets outside the originator's bankruptcy estate. A true sale is a sale of receivables that is "effective against creditors and the estate of a bankrupt originator, in that the property is no longer the property of the debtor's estate under section 541 of the Bankruptcy Code." This means that the originator no longer owns the receivables, and since the receivables are outside the originator's bankruptcy estate, the originator's creditors cannot reach them. Therefore, the SPV is not in danger of defaulting on payments to security holders should the originator go bankrupt. However, if the transfer of assets is not a true sale for bankruptcy purposes, the SPV is essentially a creditor of the originator. The SPV's status as a creditor of the originator would place the SPV at risk of defaulting on payments to security holders because bankruptcy procedure calls for a stay of all actions by creditors to obtain property of the originator. The SPV would be at risk since the stay would call for the SPV to stop paying its security holders.

2. The True Sale

Ensuring that a transaction is characterized as a true sale is an integral part of the securitization transaction. Therefore, the originator and purchaser must follow certain criteria when structuring the transaction. Factors that generally indicate a true sale rather than a secured loan include: (1) "the nature and extent of recourse that the transferee of the receivables has against the transferor;" (2) "the originator's rights to redeem or repurchase the transferred receivables;" (3) pricing based on a fixed interest index; and (4) "the administration of and control over the collection of accounts receivable." The transfer should also be a sale for tax and

82. Id.
83. STRUCTURED FINANCE, supra note 11, § 3:1.
84. Securitization Glossary, supra note 8, at 438.
85. STRUCTURED FINANCE, supra note 11, § 4:1 (internal quotations omitted). Section 541 of the Bankruptcy Code can be found at 11 U.S.C. § 541 (2000). This statute sets forth all the property that is considered to be a part of the bankruptcy estate.
86. Securitization Glossary, supra note 8, at 438.
87. STRUCTURED FINANCE, supra note 11, § 4.1.
88. Id.
89. Id.
90. See Ellis, supra note 56, at 305. "The language and form of the transaction" should reflect the party's intent to sell and not a secured loan or pledge of a security interest. Furthermore, when the parties actually transfer the assets it should be through a bill of sale or a similar formal instrument of transfer. Id. at 305 n.59.
91. STRUCTURED FINANCE, supra note 11, § 4.2. "Generally, the originator-seller should not warrant, guarantee, or indemnify the purchaser nor permit adjustments to the purchase price for the assets on account of under-performance." Ellis, supra note 56, at 305 n.59.
92. For example, "tying payment for the assets on the performance of the transferred assets will upset any attempt to characterize the transfer of the assets as a sale." Id.
93. STRUCTURED FINANCE, supra note 11, §§ 4:2-4:5. When applying these factors, the greater the amount of recourse the transferee has against the transferor, the less likely a true sale is deemed to have occurred. As far as the second factor is concerned, the absence of a right to redeem or repurchase the transferred receivables is a factor in favor of characterizing the transaction as a true sale. Furthermore, a transaction is likely to be characterized as a true sale if the purchase price of the receivables from the originator stays fixed regardless of the actual or anticipated costs of the collections. Finally, in order to constitute a true sale, the transferee should have total authority over the collection of accounts receivable. Id.
accounting purposes, and the parties involved in the transaction should send notice to third parties potentially affected by the transfer of assets.\footnote{Ellis, supra note 56, at 305 n.59. See infra Part II.D. (discussing how transfers of assets constitute sales for tax purposes).} Essentially, for a true sale to take place, the originator has to forgo his right to the residual values of the receivables sold to the SPV.\footnote{Schwarz, supra note 19, at 141.}

\subsection*{D. Tax Treatment of Asset-Backed Securities}

The tax treatment of an asset-backed security is greatly influenced by the necessity of a true sale of the assets to the SPV. Three tax issues surface in securitization transactions. These include: (1) whether the transfer of assets from the originator to the SPV will be treated as a sale or a loan; (2) the degree to which the SPV itself will be taxed; and (3) the degree to which the investors who purchase the securities will be taxed.\footnote{STRUCTURED FINANCE, supra note 11, § 5:1. The “degree” of taxation refers to the type of tax incurred, be it capital gains or ordinary income, if there is a tax exemption, and the timing of the tax.} The tax consequences of the transaction are especially important for the originator. By better understanding the tax treatment of the transaction, all parties involved can make informed choices as to whether structuring a securitization is worth the time and expense.

The originator will likely have the most concerns about the tax treatment of his transaction with the SPV. The transaction may or may not be taxed depending on whether the originator sold or loaned the receivables to the SPV.\footnote{Id. § 5:2.2.} There are several factors to determine whether there has been a tax sale, and thus a taxable event.\footnote{Id.}

Those of particular note include:\footnote{Although Schwarz lays out several factors to use in determining whether or not there has been a tax sale, only a few will be considered because of the inapplicability of the others to the topic at hand.}

- Does the originator give up the residual power of disposition of the receivables and the benefit of appreciation thereof?
- Have the specific receivables being transferred been identified?
- Does the SPV receive legal title to the receivables?
- Has the originator shifted all risk to the SPV for collection activities and given up possession and control over the transferred receivables?
- Is there evidence of the parties' intent to treat the transaction as a sale for tax purposes?

Answering yes to these questions evidences a tax sale.\footnote{STRUCTURED FINANCE, supra note 11, § 5:2.2.}

In many cases it is beneficial to the originator to avoid tax recognition.\footnote{An example of how to avoid tax recognition can be seen in the “Bowie Bonds” transaction. See infra Part III.A. By assigning the rights to receive royalties to the SPV for a set term, the originator does not give up all benefits or residual power over the receivables. Additionally, there is no intent on behalf of the two parties to treat the transaction as a sale for tax purposes. Therefore, the transfer is treated as a loan and the musician avoids tax recognition. Id.} This is especially true when the assets being transferred constitute rights to future revenue, and the income has not accrued for tax purposes.\footnote{Music royalties are an}
example of this type of right to future income. When music royalties are transferred to an SPV, the transfer is generally characterized as a loan and not a tax sale, so the artist will not have to pay taxes on the money he receives in the transaction.\(^{104}\) However, if the transfer is characterized as a sale, then a taxable event occurs and the money he or she receives will be included in his or her gross income for the tax year in which the transaction occurred.\(^{105}\)

The degree to which the SPV itself is subject to taxation depends mainly on the structure of the SPV.\(^{106}\) It is most desirable for the SPV to avoid taxation since there is no external funding to pay the taxes.\(^{107}\) Securitizations structured as pay-through transactions generally require a trustee to actively manage cash flows to ensure that the debt securities will be paid at their maturities,\(^{108}\) and to enforce legal remedies associated with copyright infringement.\(^{109}\) Because the SPV's assets have to be actively managed by a trustee, it cannot qualify as a nontaxable grantor trust.\(^{110}\)

Because an SPV cannot qualify as a non-taxable grantor trust, it would be most advantageous for the SPV to receive partnership tax treatment.\(^{111}\) Under Treasury Regulation section 301.7701-2, business entities not classified as a corporation can elect to be classified for federal income tax purposes as a partnership.\(^{112}\) Partnerships do not get taxed at the entity level. Instead, the members of the partnership are taxed.\(^{113}\) This means that the SPV will not have to use the income from the receivables to pay taxes. Instead, because of the partnership tax treatment, investors will be taxed on their earnings.\(^{114}\) Additionally, due to the pay-through structure of the SPV, interest paid on the securities will be treated as the taxpayer's ordinary income.\(^{115}\)

### III. COPYRIGHT ISSUES AND THE EXAMPLE OF BOWIE BONDS

#### A. Bowie Bonds

In the late 1990s, a new type of securitization was introduced to the financial world when singer David Bowie converted his future royalties from record sales into securities and sold them in a private placement offering.\(^{116}\) The $55 million private placement securitized licensing fees and royalty payments generated from

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104. See, Dilks v. Comm'r, 15 B.T.A. 1294, 1300 (1929) (noting that loans constitute contemporaneous obligations to repay and are therefore not taxed).
106. STRUCTURED FINANCE, supra note 11, §5:2.3.
107. Id.
108. Id.
110. SPVs structured as pass-through transactions are given the tax classification of a grantor trust. STRUCTURED FINANCE, supra note 11, § 5:2.3.
111. Id.
113. 26 U.S.C. § 701 (2000). ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on the business as partners shall be liable for income tax only in their separate or individual capacities.")
114. See id.
115. See 26 U.S.C. § 61(a)(4). ("Gross income means all income from whatever source derived, including...[interest."])
116. Fairfax, supra note 6, at 442.
the sale and use of more than 250 of his songs from his catalogue.\textsuperscript{117} David Bowie's deal was expected to trigger a host of similar transactions. However, in the end only a handful of royalty-backed securitizations were completed.\textsuperscript{118} Bowie's Bonds shed light on the many benefits and problems associated with securities that involve copyrights, and left many investors wondering, “is there life on Mars?”\textsuperscript{119}

Royalty-backed securitizations are similar to other asset-backed securities in that valuable receivables, the royalty streams, are bundled together and sold as securities.\textsuperscript{120} These securitizations begin with a musician assigning his rights to receive future royalty payments to an SPV.\textsuperscript{121} The royalty payments assigned to the SPV are generated from a song being played on the radio, in a movie, or a commercial.\textsuperscript{122} Needless to say, the more popular and timeless a particular song is, the more successful the security that contains that song will be.\textsuperscript{123} Generally, royalty-backed securities are issued as bonds, and repaid over a fixed number of years from the income generated from the royalty stream.\textsuperscript{124} Additionally, many of these transactions benefit from the guarantee of an established record company or another third party in order to earn a higher credit rating.\textsuperscript{125} As a result of the guarantee, the bonds are able to pay out lower interest rates and raise capital more inexpensively.\textsuperscript{126} The artist’s copyright also serves as collateral for the bonds in case of default in payment.\textsuperscript{127} Once the issued bonds mature, the copyright is released and the royalty payments revert back to the artist.\textsuperscript{128} “Because the securitization process focuses on the quality of the asset being securitized, the key consideration for a successful royalty-backed securitization is the quality of the royalty stream underlying the security.”\textsuperscript{129} This demonstrates just how important the underlying assets of a security are. Without predictable payment streams, securities are only attractive to the most speculative of buyers.

Securitization can provide a number of benefits to musicians and the music industry in general. Just like other asset-backed securitizations, royalty-backed securitizations allow artists to raise money quickly and inexpensively.\textsuperscript{130} Royalty-backed securitizations also increase a musician’s liquidity by providing him with

\begin{footnotes}
\textsuperscript{117} Id. at 459.
\textsuperscript{118} Id. at 461. These included private offerings of music catalogues containing songs like “Stop! In the Name of Love,” and “Ain’t No Mountain High Enough.” Id. at 461–62. In 1999 a securitization transaction was completed for securities backed by royalties from 750 of James Brown’s songs. Id. at 462.
\textsuperscript{119} DAVID BOWIE, Life on Mars (1973).
\textsuperscript{120} Fairfax, supra note 6, at 464.
\textsuperscript{121} Id.
\textsuperscript{122} Id.
\textsuperscript{123} For example, The Beatles’ “Can’t Buy Me Love” or “Born to Run” by Bruce Springsteen.
\textsuperscript{124} Id.
\textsuperscript{125} Id. at 464–65.
\textsuperscript{126} Id.
\textsuperscript{127} Id. at 464. The necessity of actual ownership of the copyright raises many impediments to royalty-backed securities.
\textsuperscript{128} Id.
\textsuperscript{129} Id. at 465.
\textsuperscript{130} Id. David Bowie actually decided to securitize his music catalogue while he was in the process of negotiating a new distribution deal. His business manager found that the amount of money he could raise through securitization was much more than bids he received from major record companies. Id. at 467.
\end{footnotes}
immediate cash, as opposed to waiting for his future royalty revenues.\textsuperscript{131} However, many musicians may not be able to take advantage of royalty-backed securitizations because of copyright issues.\textsuperscript{132} The music industry can also benefit from securitization because record labels may be able to turn to royalty-backed securitization to raise capital for recording albums or promoting their artists.

The tax treatment of royalty-backed securitizations provides artists with yet another benefit. Royalty-backed securitizations require only that the artist assign his royalty payments to the SPV for a set number of years.\textsuperscript{133} The rights to receive the royalties then transfer back to the musician after the bonds mature.\textsuperscript{134} Due to the nature of this transaction, the money the artist receives from the securitization is viewed as a loan for tax purposes.\textsuperscript{135} This means that the musician does not have to pay taxes from the money he receives in the transaction.\textsuperscript{136}

\section*{B. Copyrights}

One of the main impediments associated with royalty-backed securities, and with other securities backed by intellectual property, is the copyright.\textsuperscript{137} The Copyright Act states that the ownership of a copyright is distinct from ownership of the material object in which the work is embodied.\textsuperscript{138} This means that a transfer of the ownership of the material object is not necessarily a transfer of the copyright ownership.\textsuperscript{139} The SPV's ownership of the copyright is necessary for a successful securitization. This is because the security holders and SPV must be able to take advantage of legal safeguards that are available only to the copyright holder.\textsuperscript{140} Legal safeguards include instituting copyright infringement suits and establishing priority over creditors in the event of the originator's bankruptcy.

As with other types of securitizations, investors must be able to have a remedy should the bonds default. Using the copyright as collateral is a viable solution. This, however, requires that the SPV actually have an ownership interest in the copyright.\textsuperscript{141} A transfer of copyright ownership to the SPV is not valid unless "an instrument of conveyance, or a note or memorandum of the transfer, is in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent."\textsuperscript{142} Additionally, the Copyright Act requires that a transfer of copyright

\begin{itemize}
  \item \textsuperscript{131} Id.
  \item \textsuperscript{132} Id. at 466; see infra Part III.B. (discussing copyright issues associated with asset securitization).
  \item \textsuperscript{133} Fairfax, supra note 6, at 459.
  \item \textsuperscript{134} Id.
  \item \textsuperscript{135} Id. at 467. A detailed discussion of the tax consequences of a securitization can be found at supra Part II.D.
  \item \textsuperscript{136} Fairfax, supra note 6, at 467–68.
  \item \textsuperscript{137} The Copyright Act states that "[c]opyright in a work...vests initially in the author or authors of the work." 17 U.S.C. § 201(a) (2000). Furthermore, if a work is made for hire, the person who commissioned the work is deemed to be the author for purposes of title, and unless an agreement is made to the contrary, the person who commissioned the work owns the copyright. Id. § 201(b).
  \item \textsuperscript{138} Id. § 202.
  \item \textsuperscript{139} Id.
  \item \textsuperscript{140} Fairfax, supra note 6, at 478.
  \item \textsuperscript{141} Id.
  \item \textsuperscript{142} 17 U.S.C. § 204(a).
\end{itemize}
Ownership be recorded in the U.S. Copyright Office. Therefore, the originator must transfer the copyright to the SPV and register the transfer with the U.S. Copyright Office in order to ensure that investors may have claim to the copyright in the event of default.

Ownership of the copyright is also crucial in order to confirm that there has been a “true sale” to the SPV. As mentioned above, a true sale occurs when the sale is such that under bankruptcy law it removes the receivables (in this case the copyright) from the originator’s bankruptcy estate. If the originator declares bankruptcy, the copyright will not be at risk of coming within the creditors’ reach if the ownership interest in the copyright is vested in the SPV.

A perfected security interest in the copyright enables investors to establish priority over creditors should the originator go bankrupt. In bankruptcy actions, a lien creditor will generally take priority over any unperfected security interests. This is because unperfected security interests are subordinate to lien creditors’ rights. Therefore, if the transaction is structured properly the investors will not have to get in line with other creditors should the originator default. Since the SPV owns the copyright, the investors could just keep collecting from its revenue stream and the originator’s bankruptcy would not be an issue.

Finally, ownership of the copyright by the SPV is necessary in order to enforce legal remedies associated with copyright infringement. Only parties that have registered their copyright with the U.S. Copyright Office may institute a copyright infringement suit. Those who have a registered copyright may also recover statutory damages, costs, and attorneys’ fees. SPVs that issue securities backed by assets with copyrights will need to engage a third party to manage the assets because one of the key functions in a transaction involving a copyright is to manage and protect the copyrights. By performing this safeguarding function, the SPV can maintain the income stream from legitimate uses of the copyrighted work. The collateral manager may also initiate copyright infringement suits. However, enforcing legal remedies as a result of copyright infringement hinges on the initial

143. Id. § 205.
144. Schwarcz, supra note 19, at 135. However, in royalty-backed securitization transactions, many artists simply assign the copyright to the SPV for a set number of years, and when the bonds mature, the right to receive royalties reverts back to the artist. Fairfax, supra note 6, at 459. Such a transaction raises questions as to whether a true sale has occurred for purposes of bankruptcy remoteness—an issue that is beyond the scope of this paper. But see supra Part II.C.1 for a discussion on bankruptcy remoteness. Additionally, although this type of copyright assignment may work well for the music industry, it may not be possible for other types of intellectual property because of the SPV’s need for actual ownership of the work. For example, for artwork to achieve its highest possible value, an owner would want title to both the physical piece of work and the copyright. For a further discussion see infra Part IV.D.
145. Schwarcz, supra note 19, at 135.
146. In re Peregrine Entertainment, Ltd., 116 B.R. 194, 205 (C.D. Cal. 1990). Perfecting the security interest in the copyright means registering the copyright transfer with the U.S. Copyright Office. Id.
147. U.C.C. § 9-301 (2000) (“An unperfected security interest is subordinate to the rights of...a person who becomes a lien creditor before the security interest is perfected.”)
150. Id. §§ 504–505.
151. See supra note 140 and accompanying text.
152. See Fairfax, supra note 6, at 472.
"true sale" of the copyrighted work. A "true sale," as opposed to a temporary assignment of the copyrighted work to the SPV ensures that the SPV has all legal rights to the copyright.

IV. THE SECURITIZATION OF ARTWORK

A. The Emergence of Art as an Investment Class

The art market has been receiving special attention lately due to record high auction prices. In both November of 2007 and February of 2008, despite fears that collectors would be hesitant to pay millions of dollars for art due to the subprime mortgage crisis, record prices were recorded in the fall auction series. As a result, wealthy hedge-fund managers, art investment firms, and entrepreneurs are jumping on the bandwagon. Financial firms like UBS and Deutsche Bank have added art-advising positions to advise clients who want to purchase art because art sales have recently begun to be priced and compared with other assets. Although auction prices might not continue to rise astronomically, art has shown itself to be an investment class with staying power.

The performance of artwork compared to stocks and bonds is yet another reason why art is being viewed as an asset class. Professors Jianping Mei and Michael Moses developed the Mei-Moses Index, which measures art prices based on auction sales over the past fifty years with related purchases going back over 200 years worldwide. The Index charts different collecting categories, including American, Impressionist and Modern, Old Master and 19th Century, Post-War and Contemporary, and Latin American. In the last twenty-five years all of the art categorized by the Mei-Moses Index has slightly underperformed U.S. Treasury ten-year notes. However, the Post-War and Contemporary (PW&C) category has outperformed U.S. Treasury notes over the last twenty-five years, with PW&C providing an 11.87 percent compound annual return compared to the U.S. Treasury ten-year notes’ 10.33 percent return. Over the last ten years, the All Art and

154. British artist Damien Hirst’s "For the Love of God" recently sold for $100 million. The piece is a life-size, platinum cast of a human skull covered with 1,106.18 carats of pavé-set diamonds. After the sale, "For the Love of God" instantly became the most valuable piece of art by a living artist. Additionally, an unnamed investment firm purchased it, while Hirst retained an ownership stake in the work, which led to speculations that it was purchased just as a means of creating a market for the work. Khezri, supra note 1.

155. Vogel, supra note 1. In the February 2008 Sotheby’s Impressionist and Modern Art Sale many records were set. Carol Vogel, Sigh of Relief From the Nervous London Auctions, N.Y. TIMES, Feb. 8, 2008, at E33. For example, their sales total, $230.5 million, was Sotheby’s highest total ever for an Impressionist and Modern art sale in London. Id. at that same auction, “Schokko With Wide-Brimmed Hat” by Alexej Jawlensky brought $18.6 million, which was double what the artist brought in auction in 2003. Id. Sotheby’s also set a record total for their auction by bringing in $315.9 million in November of 2007. Carol Vogel, Big Prices for Bacon Paintings Lead Sales of $315.9 Million, a Record Total for Sotheby’s, N.Y. TIMES, Nov. 15, 2007, at B4. Interestingly enough, although it appears the rocky financial markets did not stifle the art auctions, 82 percent of the buyers were European, while only 13 percent were American. Vogel, Sigh of Relief, supra.

156. Khezri, supra note 1.

157. Id.


159. Id. at 4.

160. Id. at 7.

161. Id.
PW&C categories have outperformed Treasury notes and stock indexes. In that time period, the All Art category recorded compound annual returns of 8.54 percent, and the PW&C 15.23 percent. In contrast, U.S. Treasury 10-year notes recorded a 6.87 percent return, and the S&P 500 total return was 8.36 percent.

The year of 2006 posted even higher returns, especially for the PW&C category, which saw an annual return of 45.03 percent. Additionally, the All Art category saw an annual return of 18.27 percent. In comparison, the S&P 500’s annual return was 15.79 percent, and U.S. Treasury notes only 2.68 percent. As the data shows, art has outperformed both the S&P 500 and U.S. Treasury bonds—especially in recent years. The chance of making such large returns may be quite attractive to investors looking for alternative investments.

Finally, many financial analysts are viewing ownership of artwork as integral to a diversified investment portfolio. According to Michael Moses, one of the founders of the Mei-Moses Index, although art returns are slightly more unpredictable than the S&P 500 stock index, “it provides potentially good diversification for a portfolio, and it would be silly to ignore it.” As a result of the Mei-Moses analysis of the long-term price development of artwork, it has been projected that an investment portfolio that includes artwork provides a better risk-to-return tradeoff. Although there may be a greater risk associated with investing in art rather than stocks, the returns are greater. This is a result of the fact that the art market is informationally inefficient. However, this inefficiency creates possibilities of generating alpha returns. This may be very attractive to some investors who wish to exploit the inefficient market. Because art indices, specifically the Mei-Moses Index, show that artwork has recently outperformed other traditional investments, the time is right for alternative investments. With these issues in mind, investors can reap the returns of these types of assets by structuring investment vehicles.

B. Structuring the Security

The structure of a securitization is dictated by the nature of the assets being securitized. What works for music royalties or home loans will likely not work for artwork. Regardless, all securitizations start with pooling together the assets the
SPV will be using to back the securities it issues. There are numerous ways to organize and pool together the artwork. Many different people or organizations may serve as originators in the securitization. For example, the originator may be an individual with an extensive collection of Impressionist paintings that he would like to sell to raise capital for other investments or to purchase new artwork. An artist may wish to take advantage of a securitization opportunity since the transaction would convert future payments from sales or licensing of his artwork into instant cash. A cash-poor museum may also serve as an originator so that it can raise money for operational costs, or to purchase new collections. Other potential originators include art galleries, investors who may purchase art solely in the hopes of securitizing it, or financial institutions. Assuming that the goal of the transaction is to achieve bankruptcy remoteness, once the asset pool is established, the originator must transfer the assets, along with the artworks’ copyright, to the SPV in a true sale. Once that transaction is completed, the SPV must be structured in a way to best suit the situation.

An SPV structured as a pay-through transaction is the most logical organization for art securitization. This means that the SPV would issue investors bonds that would be secured by the assets and rates of return based on their anticipated cash flow. The bonds would then be repaid with interest over a fixed number of years from the income generated from the artwork. The income stream comes from selling, auctioning, consigning the piece, and licensing the copyright. To maintain the income stream and collect revenues from the assets, the SPV would need to appoint a servicer. Additionally, the SPV could appoint a trustee to oversee the servicer, and ensure that investors’ money is being put to use properly. A collateral manager could be another helpful addition to the structure of the SPV. The collateral manager is necessary in an art securitization structure because the value of artwork can be greatly enhanced by “active management of opportunity,... value,...and risk,...in addition to well-timed buying and selling.” Additionally, displaying collections or pieces in museums helps increase the value of artwork before it is sold at auction. By appointing a trustee, servicer, and a collateral manager, the SPV ensures that the assets bring in the most revenue possible.

171. See supra Part II.B.
172. See supra Part II.B.
173. This section deals mostly with an overview of how a securitization might be set up. However, transferring the assets/receivables to the SPV is a crucial part of ensuring the SPV can properly manage the copyright, etc. See infra Part IV.D (discussing issues related to the “true sale” of art to the SPV).
174. See supra Part II.B.
175. See supra Part II.B.
176. See supra notes 72–78 and accompanying text.
177. See supra note 78 and accompanying text (stating that the trustees invest “idle cash assets”).
178. Solis-Cohen, supra note 169 (internal quotations omitted). Managing opportunity means that the asset manager would need to be well-educated and informed about the art world so that he or she may be able to identify undervalued works. This is important because it will allow the SPV to realize larger returns on its investment in the work. See id. Additionally, by displaying works in gallery shows or “curating works as a collection” the asset manager can help add value to the pieces. Finally, an asset manager well-versed in the art markets would be able to identify different types of work that ensure diversified exposure to the market. Id.
180. See supra notes 72–78 and accompanying text.
A collateral manager is also necessary to protect the copyrights in the works.\textsuperscript{181} Since one of the main ways in which the SPV will bring in money is through copyright licensing, it must be able to defend against copyright infringement.\textsuperscript{182} Appointing a collateral manager will ensure that the valuable assets and their revenue streams are protected.

Another consideration in structuring the securitization is tranching. The decision of whether or not to tranch the underlying assets will depend on the size of the SPV’s issue, since SPVs with large security issuances are more likely to have multiple tranches than those with issues of $100 million or less.\textsuperscript{183} Realistically, if an artist is in the position of originator, it is unlikely that he will have a collection valued at over $100 million. However, if a museum or collector were in the position of originator, either could very easily have an issue of over $100 million. Although there are numerous benefits to tranching,\textsuperscript{184} the use and extent of tranching will depend on the type and amount of artwork being securitized.

The subprime mortgage crisis is sure to affect originator, issuer, and investor confidence in securitization structures. Due to the complex structure of the securitizations at issue in the crisis, it is likely that not even full disclosure\textsuperscript{185} could have provided investors with all the information they needed to adequately assess the investments.\textsuperscript{186} Neither investors nor rating agencies fully anticipated that the housing market would fall as deep as it did.\textsuperscript{187} This is partially because rating agencies base their estimates of future performance on past behavior.\textsuperscript{188} These “assumptions about the future are inherently based on past behaviors and values that may well have absolutely nothing to do with the present—the laxity in subprime lending in 2006 and 2007, for example, has never been seen before.”\textsuperscript{189} Therefore, because this situation had never occurred before, none of the parties involved could properly evaluate the risk of the securities.\textsuperscript{190} The art market could present the same problems since, although it is possible to predict prices for pieces of art, the value of a piece is essentially dependent on collectors’ current appetites. Due to art’s unpredictable nature, it could be very difficult to evaluate the risk of the securities.

In the subprime market, “disclosure...did not adequately address the relatively illiquid\textsuperscript{191} nature of the securities,”\textsuperscript{192} which made it was extremely difficult to find

\textsuperscript{181.} See supra Part III.B.
\textsuperscript{182.} See supra Part III.B.
\textsuperscript{183.} See supra notes 43–44 and accompanying text.
\textsuperscript{184.} See supra part II.A.
\textsuperscript{185.} Disclosure is “[t]he submission of facts and details concerning a situation or business operation.” SCOTT, supra note 15, at 109. It is generally required by the Securities and Exchange Commission that companies disclose facts about issues that will affect their securities. Id.
\textsuperscript{186.} Protecting Financial Markets, supra note 8, at 7.
\textsuperscript{187.} Id.
\textsuperscript{189.} Id.
\textsuperscript{190.} Id.
\textsuperscript{191.} Illiquid assets, unlike liquid assets, are difficult to sell without reducing the offering price to potential buyers. SCOTT, supra note 15, at 180.
\textsuperscript{192.} Protecting Financial Markets, supra note 8, at 7 n.23.
a buyer for the securities backed by subprime loans. Additionally, investors may have over-relied on ratings from rating agencies. This over-reliance is in large part due to the complex nature of the securities. However, it is also a consequence of the fact that “individual investors face relatively high costs to assess the creditworthiness of complex securities,” whereas rating agencies already have the tools in place to evaluate securities. Art-backed securitizations may also lead investors to rely on the rating agencies’ ratings, especially if an investor knows little about the art market or has never invested in artwork before. Although the long-term effects of the subprime crisis are still unknown, the overall plunge in the securities market will either leave investors with “an appetite...for alternative investments” or without interest in complex securitizations altogether.

C. Benefits to Securitizing Artwork

Securitizing artwork may be an attractive option to potential originators since it provides access to future income immediately. Securitization is not just appealing to investment firms or collectors—it may also be attractive to new artists who tend to have “shaky finances and scant prospects for improving them.” Should taking part-time jobs or teaching not appeal to some artists, they must look other places to find a source of income. Some groups have already attempted to fill this gap. The Artist Pension Trust (APT) was started as a way to provide a sense of financial security to artists. The basic premise is that once artists are selected to be a part of the APT, they will contribute twenty pieces over twenty years, with their income coming from the sale of their works and the works of other artists in the Trust. Before the pieces are sold, the APT has a “holding period” in which the pieces are placed in pre-approved exhibitions, museums, and galleries. After the holding period, the work is sold and the artist receives forty percent of the net proceeds of the sale of his work. Thirty-two percent of the net proceeds accumulate for the benefit of all the artists participating in the APT, while the APT retains the remaining twenty-eight percent for management and operating costs. The logic behind the APT is that “large and carefully managed pools of art works are more

193. Id.
194. Id. at 15 (arguing that because investors relied on credit ratings, they did not perform their own due diligence).
195. Id. Since buyers themselves were unable to ascertain all of the risks involved, they turned to the rating agencies for guidance.
196. Id. at 31. As a result of the subprime crises, there is now an argument to be made as to the true effectiveness of rating agencies in assessing new, complex securities backed by assets with unknown future behaviors.
197. Solis-Cohen, supra note 169.
199. Id.
202. Id.
203. Id.
204. Id.
likely to produce a predictable and steady revenue stream that can be sold to investors.”\textsuperscript{205} This is the same logic behind securitizing artwork. Bijan Khezri, APT’s chief executive agrees that “asset securitization will be the future.”\textsuperscript{206}

Art-backed securitizations may also be an alternative means of raising capital for art collectors as opposed to art-backed loans from the bank. The recent credit crisis has caused traditional lenders to cut back on art lending.\textsuperscript{207} This is in large part due to a wave of defaults on art-backed loans in the early 1990s caused by a correction in the real estate and art markets.\textsuperscript{208} Some banks may be afraid history will repeat itself. This concern of the banks is warranted because those who defaulted on their art loans during the early 1990s were primarily in the real estate business.\textsuperscript{209} However, when banks do issue art-backed loans, interest rates range from eight to eighteen percent.\textsuperscript{210} The rates are based on the lender’s policies, the borrower’s financial condition, and the quality of the artwork itself.\textsuperscript{211} Because of the difficulty in securing an art-backed loan, collectors may turn to securitization as an alternative way to raise capital for other investments.\textsuperscript{212}

Although art presents great alternative investment opportunities, it also allows individuals who have always wanted to own artwork, but did not have the requisite time or money for purchasing and maintaining a piece of art, an opportunity for ownership. Many years ago, a Real Estate Investment Trust (REIT)\textsuperscript{213} was unheard of. However, today it is a common and well-established investment option.

Just as people wanted to reap the reward of the real-estate market without buying an entire building, they can get into the art market without owning and caring for the paintings and enjoy the returns of this rising market...Just as the real-estate market has become a widely accepted investment class, the art market—estimated to represent over ten billion in annual sales in the United States alone—is now poised for a similar transformation.\textsuperscript{214}

Just like REITs, art-backed securitizations will make it possible for individuals with minimum capital and industry knowledge to pool together their resources and reap the rewards of their investments.\textsuperscript{215} Optimizing the value of a work requires displaying the piece in museums or in gallery showings.\textsuperscript{216} However, not all owners

\begin{itemize}
\item \textsuperscript{205} Id.
\item \textsuperscript{206} Id. (internal quotations omitted).
\item \textsuperscript{208} Id.
\item \textsuperscript{209} Id.
\item \textsuperscript{210} Id.
\item \textsuperscript{211} Id.
\item \textsuperscript{212} However, one must still consider whether the current market will impact art securitizations in the same way it has art loans.
\item \textsuperscript{213} Real Estate Investment Trusts are “[e]ssentially mutual funds for real estate.” Note, Managing the Real-Estate Investment Trust: An Alternative to the Independent Contractor Requirement, 107 HARV. L. REV. 1117, 1117 (1994). They “make it possible for people with limited capital and know-how to pool their resources, hire competent management, and seek a return on and appreciation of their capital.” 34 AM. JUR. 2D Federal Taxation § 20560 (2008).
\item \textsuperscript{214} Solis-Cohen, supra note 169 (internal quotations omitted).
\item \textsuperscript{215} 34 AM. JUR. 2D Federal Taxation § 20560.
\item \textsuperscript{216} See supra note 178 and accompanying text.
\end{itemize}
have the time or knowledge to ensure those steps are completed before selling a piece. Therefore, by investing in a securitization with an active SPV managing the collection, art investors will be able to get the most out of their investments.

D. Risks, Obstacles and Impediments Associated with Securitizing Artwork

Securitizing artwork can have many benefits and potentially be very profitable, but there are multiple obstacles and risks associated with this investment vehicle. The risk of delay or default in payment may be a potential deterrent for investors. Originators, on the other hand, may be deterred by the transaction costs associated with setting up the securitization, and the current ABS market may lead all parties involved to reconsider investing in such a unique and complicated investment.

The main risk associated with art securitization stems from art’s lack of a predictable payment stream, which leads to risks of delay or default in payment.217 Securities backed by receivables with a high predictability of repayment are generally not at risk for delay or default.218 However, an SPV issuing securities backed by assets with irregular or uncertain payment streams are placed in a high-risk situation.219 The art market differs from others in that there is no clear mechanism for predicting market values.220 The volatility of art prices is a potential stumbling block when setting up the securitization.

The risks caused by uncertain payment streams can be mitigated though third-party credit enhancement.221 Bringing in a third party with a high credit rating to back the bonds creates investor confidence because investors will not be as worried about the SPV missing a payment.222 With assets like artwork, third-party backing is also important because it allows the SPV to issue debt instruments with lower interest rates.223 Without these credit enhancements, the rating agencies may not feel comfortable issuing a high credit rating to an SPV comprised of such illiquid assets.224 This in turn would force the SPV to issue bonds with high interest rates, making the transaction less profitable.225 However, when a third party gets involved, rating agencies assign ratings to the securities based on the creditworthiness of the third party.226 Potential third parties for art securitizations include bond issuers or investment banks with art advisory sectors.

Another risk associated with art securitization is that the transaction may be too costly to warrant setting up. It is essential to find out what other financing options are available when considering structuring a securitization. For example, an art

217. See supra notes 50–53 and accompanying text.
218. See supra part II.A.
219. Fairfax, supra note 6, at 465.
220. See Madslien, supra note 200. Although there may be some uncertainty as to passing fads or the continued popularity of certain artists, royalties that back securitizations like the “Bowie Bonds” can be easily quantified through analyzing the past performance of each song. See Fairfax, supra note 6, at 469–71. This is not the case with art. Market values of pieces of art are not determined with “clear visibility and predictability.” Madslien, supra note 200. The unpredictable nature of art is surely one of the main impediments to securitization.
221. See supra note 54 and accompanying text.
222. See supra Part II.A.
223. See supra Part II.A.
224. See supra Part II.A.
225. See supra Part II.A.
226. STRUCTURED FINANCE, supra note 11, § 2:3.
A collector or museum that wants to raise capital to purchase new works would need to investigate the transaction costs of securitization, bank loans, or other types of funding. The collector or museum would need to look at the difference between paying interest on nonsecuritized financing, and interest payable on securities issued by the SPV. Additionally, the originator would have to weigh whether or not they would be willing to take part in a "true sale." If the originator does not participate in a transaction in which his art is passed on to the SPV by means of a true sale he will not be able to benefit from securitization. The only way the originator would be able to keep the piece is if he were to forgo the selling or securitization altogether and get an art-backed loan.

Finally, the slump in the ABS market may deter some potential investors. Big investment companies such as Merrill Lynch reported some of their largest quarterly losses at the end of 2007 because of subprime-related securities. This may leave many investment firms wary of new securities, especially securities backed by illiquid assets. As investment firms look for investments in more stable sources to help raise capital after multibillion-dollar losses, art-backed securitizations may not be the most attractive opportunity.

The current market could pose a sizable risk to introducing new art-backed securitizations. The subprime crisis is likely to affect investor confidence in art-backed securitizations, especially because many of the same complexities that arose in securities with subprime loans as underlying assets are present in art-backed securitizations. Just as rating agencies were unable to fully estimate the future performance of the subprime loans due to the unpredictability of art sales, it is likely the rating agencies will be unable to properly assess the future performance of the art. This means that investors will not be able to adequately evaluate the securities. Furthermore, because art is the underlying asset in the securitization, investors who are not art-savvy may simply rely on the rating agencies when deciding whether or not to invest. This investor over-reliance will lead to uninformed decisions by investors, just like those who invested in securities backed by subprime loans.

227. The terms of loans are quite different. However, most lenders base the terms on the quality of the art being used as collateral and the borrower's financial condition. The interest rates generally range from 8 percent to 18 percent. Therefore, because interest rates are so high, collectors in need of capital may seriously consider securitization. Schuker, supra note 207.

228. The only way the originator would be able to potentially keep the art is if there was not a "true sale," but the originator retained a reversionary right in the work once the securities reached maturity, like royalty-backed securitizations. However, this would undermine the ability of the SPV to sell the artwork and realize substantial income from the art.

229. Merrill Lost $9.8 Billion in Fourth Quarter, supra note 8.

230. See id. Merrill Lynch secured nearly $13 billion in outside investments, mostly comprising sovereign wealth funds controlled by foreign governments such as Kuwait and Singapore. Id.

231. Perhaps after the subprime mortgage crises settles, there could be a new day for securitizations, and art-backed securities could flourish.

232. See supra notes 185–96 and accompanying text.

233. See supra notes 188–89 and accompanying text.

234. See supra notes 188–89 and accompanying text.

235. See supra note 194 and accompanying text.
However, even amidst the subprime crisis, art auctions have still been setting records, and it does not appear that a collapse in the market is in the near future.\textsuperscript{236} This leaves hope that once the subprime storm clouds clear, some investors may be willing to take a chance on the securities.

In addition to the risks inherent in structuring art-backed securitizations, there are also multiple obstacles that have the potential of making it difficult for originators to structure an art securitization. The most prevalent obstacle in the path to securitization is a work’s copyright. Issues involving provenance, chain of title, true sale, and bankruptcy remoteness all stem from the difficulties associated with securitizing assets with copyrights. Art also presents the special challenge of moral rights, a topic that could pose problems for international transactions. Finally, taxation could prove to be a deterrent for both investors and originators.

Copyright issues are one of the biggest impediments for those wishing to structure an art-backed securitization. Actually selling the piece of art provides some of the largest returns on the initial investment.\textsuperscript{237} However, in order to sell the artwork at its highest value, there must be pristine provenance.\textsuperscript{238} The provenance of the work also takes into account who owns the copyright.\textsuperscript{239} The copyright initially vests in the creator of the work.\textsuperscript{240} Therefore, if a piece changes hands directly from the artist to the SPV, one could feel confident in the SPV’s ownership, as well as the provenance of the piece. However, if the piece comes from a collector, and the chain of title has not been documented, many issues could arise.\textsuperscript{241}

Problems that come about with undocumented chains of title stem mostly from art theft, antiquities looting, and the Holocaust restitution process.\textsuperscript{242} One example of the importance of clear title came from the owner of an Anthony van Dyck painting who consigned the work to an auction in the spring of 2004.\textsuperscript{243} The Art Loss Register, a London-based registry that tracks stolen artwork, identified the painting as one of the pieces that had been confiscated from a well-known Jewish art dealer around 1940.\textsuperscript{244} Once the painting was identified, the art dealer’s heir was...
contacted, and the auction house worked out a transaction to restitute the painting.\footnote{Id.} This example illustrates that investigation of provenance is a crucial aspect of purchasing art.

Not only does the SPV need ownership of the copyright in order to obtain a higher price for the work, it also needs to own the copyright in order to ensure it is protected from copyright infringement.\footnote{See supra Part III.B.} Additionally, if the SPV does not have an ownership interest in the copyright, it will not be able to ensure that only the SPV was profiting off the image.\footnote{See supra Part III.B.} For example, if a company produced posters with an image of one of the pieces in the asset pool, the SPV would be defenseless in trying to get the company to stop selling the posters. If the SPV did have an ownership interest in the copyright, it would have the right to enforce certain legal remedies associated with copyright infringement, such as an injunction to stop the poster company, or suing for damages from the income lost as a result of their use of the copyright.\footnote{See supra Part III.B.}

Transferring copyright ownership to the SPV is also integral to making sure that there has been a “true sale” and that the SPV is bankruptcy remote.\footnote{See supra Part III.B.} For a “true sale” to occur, the sale must be sufficient under bankruptcy laws to remove the assets from the originator’s bankruptcy estate.\footnote{See supra Part III.B.} Investors must be able to perfect their interest in the copyright in the event that the debt instruments issued by the SPV defaults.\footnote{Id. at 478.}

As a result of these two requirements, the SPV has to retain ownership of the copyright. If, for example, an artist was an originator and declared bankruptcy, his creditors could not pursue the SPV’s assets because they are not part of the artist’s bankruptcy estate.\footnote{See supra Part IIC.1.} Additionally, if the bonds issued by the SPV defaulted, the security holders would be able to repossess the copyright and exit the failed investment with at least some value.\footnote{See supra Part III.B.} Without ownership of the copyright, the SPV is unprotected against an originator’s third-party creditors, and the security holders are left without recourse in the event of default.

The artist himself may also present an obstacle to the securitization in the form of moral rights. Moral rights “address issues of integrity\footnote{“The moral right of ‘integrity’ essentially underlies the preservation of the artist’s work in its authentic and unadulterated form.” ART LAW HANDBOOK, supra note 238, § 1.04(A).} and attribution\footnote{“The right of ‘attribution’ is the right to receive credit for those uses of an artist’s work that the artist and the public should rightly associate with the artist, and conversely, to avoid derogating associations with versions of a work that are not truly representative of the artist’s efforts.” Id.} and go to the core of those privileges naturally associated with the rights of any creator.” Moral rights also encompass the ability to control publication of a work and

\begin{itemize}
  \item \footnote{Id.}{Id.}
  \item \footnote{See supra Part III.B.}{See supra Part III.B.}
  \item \footnote{See supra Part III.B.}{See supra Part III.B.}
  \item \footnote{See supra Part III.B.}{See supra Part III.B.}
  \item \footnote{Fairfax, supra note 6, at 456.}{Fairfax, supra note 6, at 456.}
  \item \footnote{Id. at 478.}{Id. at 478.}
  \item \footnote{See supra Part IIC.1.}{See supra Part IIC.1.}
  \item \footnote{See supra Part III.B.}{See supra Part III.B.}
  \item \footnote{“The moral right of ‘integrity’ essentially underlies the preservation of the artist’s work in its authentic and unadulterated form.” ART LAW HANDBOOK, supra note 238, § 1.04(A).}{“The moral right of ‘integrity’ essentially underlies the preservation of the artist’s work in its authentic and unadulterated form.” ART LAW HANDBOOK, supra note 238, § 1.04(A).}
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\end{itemize}
whether or not the author's name is used when the work is published.\textsuperscript{257} Moral rights are essentially inalienable, and even if a purchaser acquires the full copyright of the work, the artist may still have some say as to the use of his work.\textsuperscript{258} Moral rights are generally not recognized in the United States,\textsuperscript{259} but are recognized in many European countries.\textsuperscript{260} This means that the moral rights of another country may protect the work of an artist from the United States.\textsuperscript{261} Given the international nature of the art world, originators and investors must be aware of the potential implications to using and promoting the art they securitize.\textsuperscript{262}

A final cost associated with the securitization of artwork is the tax consequences. The tax consequences of a "true sale" to the SPV may be a deterrent to potential originators. A "true sale" of the artwork to the SPV will likely end up being categorized as a sale for tax purposes.\textsuperscript{263} This means that the transaction will be characterized as a taxable event, and the money the originator receives from the sale is included in his gross income for the year in which the transaction occurred.\textsuperscript{264} When the originator sells artwork to the SPV, he is transferring the right to future revenue. Since it is future revenue, the income has not actually accrued for tax purposes.\textsuperscript{265} Therefore, the originator will have to realize a substantial gain in income for the taxable year, which he otherwise would not have realized. Some potential originators may not be willing to take such a hit. Many may be more comfortable with the idea of steadily receiving revenue over the years. Furthermore, an artist who is not accustomed to taxes of such a magnitude, or a collector who does not have enough losses during the year to offset the gains, may be not be willing to enter into the transaction because of the tax consequences. It is very important that all parties have a full understanding of the potential tax consequences before entering into the transaction. It will be the job of the SPV manager to let artists and collectors know the pros and cons of securitizing their art.

V. CONCLUSION

Over the past few years the financial advantages to owning artwork have been increasingly more apparent. There is great potential for new investment opportunities as art emerges as an asset class. The securitization of artwork could be a perfect addition to the investment options currently available for art. Years

\textsuperscript{257} Id. § 1.04[B].
\textsuperscript{258} Id.
\textsuperscript{259} Id. § 1.04[C][11]. Several states, including New Mexico, have enacted statutes that provide protection for moral rights. These statutes "restrict users of works of fine art in altered or mutilated forms and grant authors a right of attribution." Id. § 1.04[C][4].
\textsuperscript{260} Id. § 1.04[A].
\textsuperscript{261} See id.
\textsuperscript{262} Although this paper does not attempt to present all the international law issues that could present a challenge to securitizing artwork, a few are of particular note. European countries, especially France, have extensive laws concerning the authenticity of artwork. Additionally, many countries also have laws concerning the droit de suite. The droit de suite is "the right of an artist to be compensated with a percentage of the sale of any subsequent sale of his works during his lifetime and for the 50 years following his death." Id. § 7.03[C][1][b]. Generally, artists' rights societies in European countries police art sales to enforce the droit de suite. Id. The awareness of laws in foreign countries will be particularly important to collateral managers of an SPV.
\textsuperscript{263} See supra Part II.D.
\textsuperscript{265} See supra Part II.D.
from now, art-backed securitizations may be as commonplace as an REIT. However it also has great potential for new artists looking to make a living through their work, or struggling museums in need of cash for operating costs or acquiring new collections. Although art-backed securitizations certainly have real potential, there may be some obstacles to overcome before a transaction is properly structured. Selling art offers the opportunity for huge returns. However, auctioning art is neither predictable, nor does it constitute a constant payment stream. Additionally, the copyright issues may pose another impediment to benefiting from a securitization. Although there are certainly risks and impediments to securitizing artwork, it could bring considerable rewards to those who choose to invest.