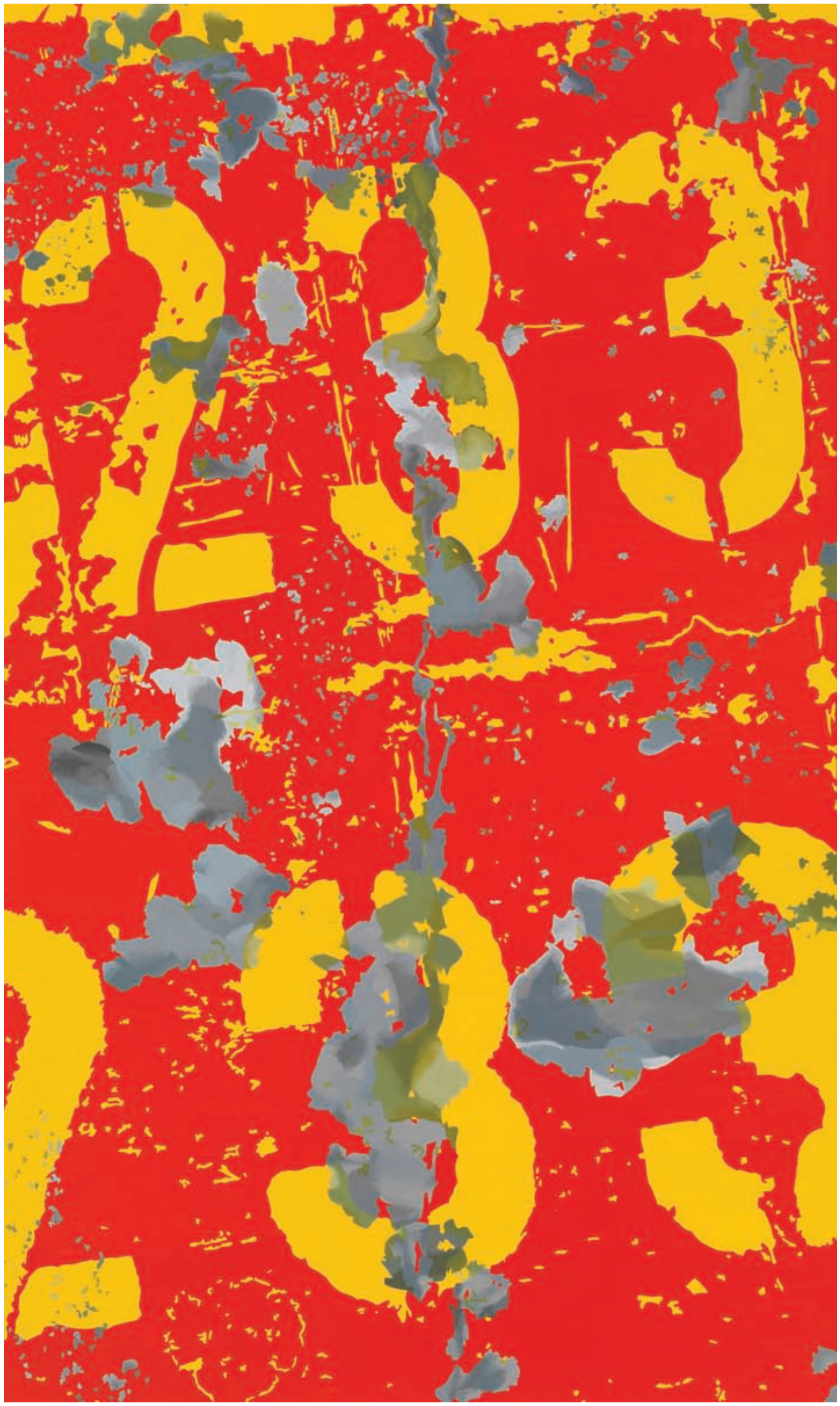
The Legal Canvas

Winter 2010–2011



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Art and Law

Art and law share a sometimes uneasy co-existence. While as lawyers we like to think that both fields speak to society's higher values, each does so in a very different way.

The rule of law establishes a framework within which society can function; it expresses a communal ethic about how society's needs are to be met and how responsibility is to be allocated. It permits civilization.

Art, on the other hand, creates, reflects and enhances civilization. At its best, it is transcendent. It pushes at the boundaries that define the way we think about ourselves and our existence.

Art law happens where these two endeavors intersect.

In this issue of the Legal Canvas, we explore a number of these intersections. In an article that grew out of a recent exhibit at MoMA, we discuss how the doctrine of "fair use" may apply to balance the rights of both artists when a photographer creates a new work of art based on a sculpture. We next look at an ongoing lawsuit involving canvases purchased at the Louis Vuitton shop that was integrated into the ©*Murakami* show at the Los Angeles Museum of Contemporary Art.

In an article about resale royalties, we examine the most recent chapter in the movement to provide artists with expanded commercial rights. And in an update on the controversy about the effort by Fisk University to sell art from its collection, we note how the judge's implementation of the law differs from the prevailing ethical view of museum associations.

In other articles, we provide updates on the Warhol antitrust litigation and the adoption of UPMIFA in New York, and a warning about sales tax liability if you are a limited partner or a member of an LLC in New York.

We hope you have a happy holiday season, and wish you all the best in the New Year.❖

Hugh Freund   Jo Laird   John Sare

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In this issue . . .

"Under What Circumstances Does a Copy Become an Original?"

This is the question posed at the beginning of the catalog issued by The Museum of Modern Art in New York in connection with its recent exhibition, *The Original Copy: Photography of Sculpture, 1839 to Today*. The exhibition explored how "[t]hrough crop, focus, angle of view, degree of close-up, and lighting, as well as through ex post facto techniques of darkroom manipulation, collage, montage, and assemblage, photographers not only interpret the works they record but create stunning reinventions."

MoMA, of course, explored the question from an art historical and aesthetic point of view. When lawyers get involved, they tend to focus on the legal issues that may attend the use by one artist (the photographer) of a copyrighted work by another (the sculptor).

These issues are squarely before a federal court in Seattle, Washington, in a lawsuit brought by sculptor Jack Mackie against photographer Michael J. Hipple. Mackie is co-owner of the copyright in a Seattle public art work entitled "Dance Steps on Broadway" ("Dance Steps") that was installed between 1981-1982. The work includes eight groupings of two-dimensional bronze shoe soles, embedded in the sidewalk, that reflect the steps to popular dances such as the "Foxtrot Weave" and the "Lindy Hop." In October 1997, Michael Hipple took a photograph of a person interacting with some of the steps for the "Mambo." Hipple submitted the photograph to a stock agency, and earned approximately $30 on the sale of the image.

Mackie sued Hipple and his stock agency, alleging a violation of his copyright in the sculpture. The stock agency settled and took the image off its website. In August, the court denied Hipple's motion to dismiss the case as time barred, and the litigation continues.

Hipple is defending the case on two grounds. First, Hipple contends that Mackie's copyright is unenforceable against Hipple's photograph because the elements of the sculpture that are contained in the photograph do not possess the level of originality necessary for copyright protection. The footsteps, after all, reflect dance steps that Mackie did not create. Second, Hipple argues that his inclusion of a portion of the sculpture in the photograph is protected by the doctrine of "fair use."

As we discussed in the Spring 2009 issue of *The Legal Canvas*, "fair use" is a legal doctrine that became the subject of widespread popular discussion after the Associated Press sued artist Shepard Fairey alleging that Fairey's iconic "Hope" poster of candidate Barack Obama violated its copyright in the photograph on which the poster was based.

The doctrine also recently formed the basis of a federal ruling in favor of a sculptor who claimed that the use of a photograph of his work on a United States postage stamp violated his copyright in the underlying sculpture. Before considering that case and the impact that it may have in the Seattle litigation, it is important to put the doctrine of "fair use" in context.

Background: What is the point of Fair Use?

The Founding Fathers considered the concept of copyright to be important enough to be included in the Constitution. Its purpose is to "promote the Progress of Science and useful Arts," and Congress is instructed to do that by "securing for limited Times" to a creator the "exclusive Right" to his or her creations. In other words, because the Founding Fathers understood that society benefits from the creativity of its citizens, they instructed Congress to provide an incentive for them to create.

The benefit to society that the Constitution seeks to promote is "progress" in science and the arts. Progress necessarily involves "conversation" – both a conversation with what has come before and a conversation among scientific and artistic contemporaries. In the arts, that conversation will from time to time include a specific reference in a work by one artist to the work of another.

Market Thoughts

In our prior issues, we have offered some of our own thoughts about the state of the art market. Over the summer, we read an essay on the market by gallerist Jane Kallir of the Galerie St. Etienne. We were struck by its insight, and are grateful that Jane agreed to allow us to reprint it here.

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The "Great Recession" has officially ended, and auctions are again breaking records, but the excesses of the past decade continue to cast a shadow over the future. Those excesses, which we now know relied largely on fraud, obfuscation and debt, concealed underlying economic weaknesses that will not easily be healed. As income disparities grew to historic levels in the 1990s and 2000s, the notion of an American middle class was sustained only by a combination of easy credit and comparatively affordable consumer goods. Yet the same factors—automation and production in low-wage countries—that made consumer goods affordable, gradually robbed much of the middle class of its livelihood. The art world had been living off the trickle-down from the liquidity generated by cost discrepancies between developed and developing nations, but when that liquidity dried up, so did the trickle.

More and more, it seems, we live in an era of winner-take-all, both within the art world and without. For a number of years now, our annual "state-of-the-market" reports have commented on the bifurcation of art values: the tendency of money to pool at the top, creating enormous gaps between the prices of works that are perceived to be extraordinary and everything else. Mirroring the income stratification seen in the economy at large, bifurcation was typical of the bubble years (roughly 2004 through 2007), and it remains a factor in the current downturn. For some dealers, this recession has been a breeze compared to the protracted slowdown of the early 1990s, or even the short-lived pall that followed 9/11. Others have sold almost nothing in over a year. The more successful dealers play musical chairs with Chelsea gallery spaces vacated by bankrupt former competitors. At art fairs, it is feast or famine: only the better fairs and the dealers with better material do well. We have experienced a true, visceral contraction, and the market is simply no longer large enough to sustain its former sales volume. But the buyers who remain, who have money, still want the best. To succeed, a dealer must aim to be in the 95th percentile or higher. There is little margin for error in pricing, choice of art sold or art fairs participated in. Below the cut-off point, business evaporates.

More than ever, buyers today want major, recognizable works by internationally established masters. In an increasingly globalized environment, it is important that an artist be as renowned in Moscow or Abu Dhabi as he (or, far less frequently, she) is in New York or London. Works by artists with global reputations can more readily be used to hedge against currency fluctuations and volatile investments like stocks; such art, figuratively and perhaps literally, is as good as gold. Within this context, "masterpieces" with "wall power" can command prices comparable to those of the bubble period. Nonetheless, the much-touted return of record-busting auctions has been achieved in a climate of drastically reduced presale estimates. Auctioneers have long been skilled at driving up bids by steering their wealthiest clients to the same handful of lots and employing estimates to manipulate public expectations. The terms used to judge the success of a given sale are set largely by the auction house itself, rather than by any objective measure. Blockbusters aside, the latest Impressionist/Modem evening sales reflected a welcome stabilization of the market, but at significantly lower values than might have been realized three years ago. A shrunken market has compelled auctioneers and dealers alike to reduce prices.

That reference can be as subtle as a color, or as brazen as the wholesale appropriation of an image.

In deciding where to strike the balance between the "exclusive Right" of an artist to benefit from his work, and the benefit to society of allowing another artist to use that work for certain purposes, the courts often look to "fair use." Codified in Section 107 of the copyright law, the doctrine provides that the reproduction of another artist's work may be considered fair (and therefore permissible without getting the other artist's permission) when it is used for purposes such as criticism, comment, news reporting, teaching, scholarship, and research. Whether the particular use *is* fair is determined by considering four

For some observers, the semi-annual auction sales are the closest thing the art world has to a stock exchange; the only way to publicly gauge the art market's strength. However, during an economic contraction, auction is not necessarily the best way to value or sell art. The top lots on offer in a given season quickly suck up all the available resources, while lots that, for whatever reason, fail to generate the necessary salesroom buzz languish. Even at the glamorous nighttime sales, the critical mass of potential buyers necessary to spark competitive bidding is often missing on many lots. Unless or until prices start to rise across the board, auction will present a risky bet for sellers. A given auction result, far from reflecting the market as a whole, merely provides a snapshot of a single moment in time, very much dependent on such vagaries as other simultaneously available lots and the presence or absence of key bidders.

There was a time, beyond the memory and experience of many art-world players today, when auctions were chiefly wholesale operations. The majority of buyers then were dealers, who provided essential liquidity by holding their purchases until such time as the art could be absorbed into a comparatively small market. Dealers also provided value-added in the form of knowledge that was generally superior to that of auction-house personnel. A. Alfred Taubman, the shopping-mall magnate who bought Sotheby's in 1983, is usually credited with transforming auctioneering into a retail business, though Christie's quickly followed suit. However, the transformation was never entirely complete; there were always sales categories (prints, for example) where auction results remained closer to wholesale than retail. In some respects, auctions are now reverting to their wholesale function. This is due not only to market shrinkage, but to the auctioneers themselves, whose neglect of lower-priced lots can leave potential retail buyers floundering.

These days, it is often dealers who make the market: picking up the slack at auction and providing sellers with more reliable returns on their art. Competent dealers are able to thread their way through the schizophrenic atmosphere created by record prices and high buy-in rates at auction and to accurately value works of art based on aesthetic quality, the potential supply of comparable material and collector demand. In this way, dealers can provide a necessary corrective to the excesses of the bubble years, suggesting a rational alternate pricing paradigm. It remains to be seen whether an eventual economic recovery will produce a sustained resurgence of top-heavy aggressive bidding. For now, most speculators have been driven from the field by declining prices, and committed collectors are reaping the benefits. If there is a silver lining to the art market's grey cloud, it is that periods of retrenchment encourage a return to the fundamentals of connoisseurship.

On the other hand, the ongoing stock-market gyrations, currency fluctuations and persistent unemployment indicate that the financial crisis has not yet run its course. Beyond subprime mortgages and deceptive derivatives, the crisis had its roots in a massive economic shift that has dispersed corporate interests across the world, eroding the authority of traditional nation-states and leaving many individual citizens caught in the undertow. The tea-party movement in the United States and mass protests stretching from Bangkok to Paris all involve people who feel displaced by the new global economic order. Within the art world, too, many people—artists, collectors, dealers—are being left behind. Certain segments of the art market simply will not be coming back, just as portions of the American economy will not recover from the "Great Recession." Economists blithely call it "creative destruction," but it is destruction nonetheless.

By Jane Kallir

factors on a case by case basis: the purpose and character of the infringing use; the nature of the underlying work (is it more creative or more factual); the amount and substantiality of the portion of the underlying work that is used; and the impact that the infringing use may have on the market for the underlying work itself or derivative works based on it.

In recent years, the first factor – the purpose and character of the infringing use – has become a predominant focus in cases involving the application of the fair use doctrine to works of art. And, more and more, the analysis of that factor has revolved around the question of whether the use is "transformative." As articulated by Judge Pierre Leval in a seminal article in the *Harvard Law Review*, in order to be transformative, the "use must be productive and must employ the quoted matter in a different manner or for a different purpose from the original. A quotation of copyrighted material that merely repackages or republishes the original is unlikely to pass the test…. If, on the other hand, the secondary use adds value to the original – if the quoted material, is used as raw material transformed in the creation of new information, new aesthetics, new insights and understandings – this is the very type of activity that the fair use doctrine intends to protect for the enrichment of society." The Supreme Court has adopted Judge Leval's notion of transformative use. Over time, the concept has been expanded to include not only changes to the original work, but also uses that facilitate the development of information and education.

Gaylord v. United States – When a memorial sculpture becomes a commemorative postage stamp.

Under the American common law system, the meaning of a statute (particularly one that requires the determination of issues that are as subjective as the factors at issue in the fair use doctrine) is interpreted and developed over time by the application of the statutory provisions to the very specific facts of individual cases. As each case is decided, the law becomes clearer – each decision adding a pixel to a picture that is still unfinished. In February 2010, the United States Court of Appeals for the Federal Circuit added another data point, applying the fair use statute to a case involving an image on a postage stamp.

When Congress passed legislation authorizing the creation of the Korean War Veterans Memorial, a team from Pennsylvania State University submitted the winning proposal for its design. The work would feature a group of stainless steel statues of foot soldiers, titled "The Column." As described in the original proposal, "[f]rom a distance," the statues would have "an elusive, dream-like presence of ghostly figures moving across a remote landscape." Ultimately, sculptor Frank Gaylord was commissioned to complete the Memorial based on the Penn State proposal. Gaylord registered five copyrights related to "The Column" throughout the construction process, each capturing a different design phase. The Memorial opened to the public in 1995.

In January 1996, as a gift to his father, a Korean War veteran, photographer John Alli took a photograph of "The Column" that he titled "Real Life." The photograph captured 14 of the 19 soldiers in the sculpture covered in snow on a grey morning. When Alli decided to sell the photograph, he sought and received permission from the party whom he mistakenly believed owned the copyright. In exchange for the permission, Alli agreed to pay that party a 10% royalty on sales. The party did not notify Gaylord about the transaction; Gaylord sued Alli for copyright infringement; and the case was settled out of court.

In 2002, the United States Postal Service issued a thirty-seven cent stamp using Alli's "Real Life," entitled "Korean War Veterans Memorial." The Postal Service paid Alli $1500 for the use of the photograph, but never contacted Gaylord to obtain a license to use the image of the underlying sculptural work. The Postal Service received almost

$17 million in revenue from the sale of almost 48 million stamps; $5.4 million of that revenue was from sales of stamps to collectors who did not use them. In addition, the Postal Service sold other merchandise depicting the stamp.

Gaylord brought suit against the Government, alleging copyright infringement. The Government argued that the use of the image of the Memorial on the stamp was protected by the fair use doctrine. The trial court agreed, and Gaylord appealed.

On appeal, the Postal Service argued that the photographer's choice to capture the figures covered in snow, graying the color to create an image where one could not determine whether the soldiers were human or statue, transformed the character of the copyrighted work and therefore satisfied the first factor of the fair use analysis. The Court of Appeals for the Federal Circuit rejected the argument.

In its decision, the Court methodically addressed each of the four statutory factors, finding that the first three mitigated against a finding of fair use. It found that the stamp had no different or further purpose than the Memorial itself; for each, the purpose was to honor Korean War veterans. Nor did the photographer's decision to photograph the sculpture in the snow (as opposed to warm sunshine) "transform its character, meaning, or message." The Court also found that the revenues that the Postal Service earned through the sale of the stamp clearly reflected a commercial purpose, a criterion that weighs against fair use. The Court next addressed the nature of the sculpture as the underlying work, finding that it was "expressive and creative," as opposed to factual and explicative. The Court also found that the stamp used a substantial portion of the sculpture – 14 of the 19 figures in "The Column." Indeed, the image of "The Column" was both the graphic and conceptual point of postage stamp's design.

The only factor that the Court found to support a finding of fair use was the final one. The Court held that the stamp did not have a negative impact on the market for derivative works – in other words, the fact that the image was used on the stamp was unlikely to affect Gaylord's ability to profit from other works based on the image. Weighing the four factors, the Court concluded that "[e]ven though the stamp did not harm the market for derivative works, allowing the government to commercially exploit a creative and expressive work will not advance the purposes of copyright in this case." The Court found in Gaylord's favor, and sent the case back to the lower court to determine damages to be paid by the government for copyright infringement.

How might *Gaylord* affect Mackie?

The *Gaylord* case did not determine whether the photograph of the Memorial was *itself* protected by the fair use doctrine. The Court's ruling was that the use of the photograph on a postage stamp was not. Its analysis may have been very different had Alli not settled with Gaylord and had been sued for infringement.

The factual record has not yet been developed in the Mackie case, but based on the allegations in complaint, the court's opinion on Hipple's motion to end the case, and a series of press interviews, there is some reason to believe that the outcome of the case may be different than the outcome in *Gaylord*.

The most compelling (and perhaps legally significant) difference between Hipple's picture of the Seattle sculpture and Alli's picture of "The Column" is the extent to which Hipple staged and designed the image. The Gaylord Court dismissed the artist's decision to photograph the sculpture in the snow as "Nature's choice," and said that it did not change the purpose or character of the underlying work. In photographing the sculpture in Seattle, Hipple arguably took a more active role in creating his image, adding the leg of a person interacting with the dance steps. The leg enters the frame from the top left corner of the photograph and becomes the deliberate focus of the image. The picture becomes less about the sculpture and more about the person who is dancing on it; less about the disembodied concept of dance and more about dance itself. Whether the image of the sculpture will be determined to be transformative is still an open question, but it appears to be a closer call than it was in *Gaylord*.

A fertile ground for litigation.

There will always be some level of uncertainty in fair use cases. The four fair use factors are predominantly factual and the weighing of them subjective. The outcomes then will depend in large part on who is deciding the case. Different people, and therefore different judges, will each have his or her own view of whether an image has been "transformed."

Cases involving certain forms of contemporary art can be particularly dependent on the court's willingness to entertain and accept fairly sophisticated art theory. A judge faced with a copyright claim involving a straight photograph of another artist's sculpture may or may not be willing to accept the photographer's argument that his appropriation of the image was intended to parody the work, to comment satirically on society, or to serve some other purpose different from the purpose served by the sculpture itself.

A potential plaintiff is unlikely to bring a lawsuit when he or she knows that there is no chance of winning. But where the outcome is at least uncertain, there is an incentive to litigate or to threaten litigation. And, because litigation costs money, the threat of litigation creates leverage to procure a settlement.

One way for an artist to avoid litigation is simply to get permission from the artist whose work he is seeking to use. With a license from the original artist, the doctrine of fair use doesn't even come into play and each artist's rights are clear. Alli took that step with Gaylord and the subsequent litigation did not challenge Alli's photograph of the sculpture, only the government's use of it.

Many artists, however, prefer not to seek permission for their art. In some cases it is a matter of sheer artistic pride. In others, though, it relates back to the concept of "conversation" – one artist's ability to comment on the work of another should not depend on the willingness of the other artist to receive the comment. Encouraging and protecting this conversation, and the progress in the arts that it engenders, is the purpose of the copyright law in general and of the fair use doctrine in particular. But in a litigious society, what the law of fair use gives, the uncertainty and expense of litigation may take away (or at least modify).❖

For more information on this topic, contact Gloria Phares at 212 336 2686, or gphares@pbwt.com or Jo Laird at 212.336.7614 or jblaird@pbwt.com. **The assistance of summer associate Maya Goree is gratefully acknowledged.**

Defending Fair Use Against Technological Blocks

It is an understatement to say that technology has vastly expanded the ability to access copyrighted material. You need time, patience, or a resident 16 year old to keep abreast of changes.

Some of that increased access has been accomplished at the expense of copyright holders. If, for example, users can figure out a way to download music for free, copyright holders are denied compensation for the use of their copyrighted works – and therefore the incentive, as stated in the Constitution, to "promote the Progress of Science and useful Arts." Not surprisingly, copyright holders who publish work in digital format have sought to create ways to block access to non-paying users.

In 1998, the Congress passed the Digital Millennium Copyright Act ("DMCA") as a means of assuring that the balance intended by the copyright laws is preserved in an age of technological change. Among other things, the DMCA generally prohibits the circumvention of technology that controls access to copyrighted material. However, because this prohibition could limit the availability of works that are no longer in copyright and the fair use of works that still are, the DMCA also requires the Librarian of Congress, on the recommendation of the Register of Copyrights, to determine every three years whether access-control technologies are preventing individuals from using works in legitimate, non-infringing ways.

On July 27, 2010, Librarian of Congress James H. Billington issued the most recent set of regulations, identifying six kinds of use that should be exempt from the protective provisions of the DMCA. Two of those exemptions have particular relevance to the art world.

Using Portions of Movies for Commentary

The first exemption allows colleges and universities, documentary filmmakers, and producers of noncommercial videos to sidestep the digital rights management system used to protect DVDs from copying, but only for the purpose of incorporating short portions of the movies on those DVDs into compilations for the purpose of commentary.

This type of use is protected by the fair use doctrine and therefore does not infringe the copyright in the copied movies, but the movie industry's use of copy-protection schemes on DVDs has frustrated attempts to access those movies for non-infringing purposes. This exception allows professors and students, documentary filmmakers, and laymen to freely use content from DVDs to create non-commercial video essays, documentaries, and "mash-ups" for the purposes of commentary and criticism without fear of being charged with violating the DMCA.

Note that the exemption applies only to the circumvention of access controls for DVDs, and not to other technologies used to distribute movies, such as Blu-Ray discs or streaming media technology.

Using Text-to-Speech and Accessibility Features with Electronic Books

This exemption, which has been carried over from the previous list of exemptions, allows readers of electronic editions of books to circumvent access controls that prevent the use of text-to-speech functions or the rendering of the book's text into a specialized format.

The exemption was primarily driven by concerns for the blind and visually impaired; instead of seeking out a Braille or a large-print edition of a book, one could purchase the ebook version and use the text-to-speech or accessibility features on a computer or an ebook reader. But some developers of ebook readers had been pressured by the publishing industry to disable these features. Last year, the Authors Guild pressured Amazon into allowing publishers to disable the text-to-speech function on Amazon's Kindle ebook reader, with the authors arguing that making the text-to-speech feature available for ebooks hurt sales of audiobook versions of the same book. This exemption guarantees that users of the text-to-speech and accessibility features of these readers won't be prosecuted for using these features to read ebooks.

For more information on this topic, contact Eric Rasmussen at 212.336.7896 or erasmussen@pbwt.com, or Gloria Phares at 212.336.2686 or gcphares@pbwt.com.

Art Meets Commercialism Meets Lawsuit: Blurring the Line Between Art and Merchandise can be Perilous.

One of the best-known endeavors of celebrated pop artist Takashi Murakami is his collaboration with Louis Vuitton. As part of Murakami's ongoing and controversial exploration of commercialism and art, the artist produced a series of textile patterns for the luxury goods manufacturer that have appeared on handbags, wallets, luggage and other merchandise since 2002.

In 2007-2008, the Los Angeles Museum of Contemporary Art presented a retrospective of Murakami's work entitled *©MURAKAMI*. The exhibition subsequently traveled to the Brooklyn Museum. To underscore the artist's signature theme, the show included a functioning Louis Vuitton boutique where visitors could purchase Vuitton merchandise. In addition to items like handbags, the items for sale included a series of 16"x16" stretched canvases with Murakami's versions of the traditional Louis Vuitton pattern. The canvases consisted of the same material that had been used in the manufacture of the handbags. The works were produced in limited edition series of 100 in each of five different patterns and were described in a promotional brochure as being canvases that had been "revisited" by Murakami. Each canvas sold at an average price of $8,000, for an aggregate retail value of $4 million. Accompanying each print was a certificate of authenticity stating that "the Editioned Canvas . . . is an original artwork produced in collaboration between Louis Vuitton and artist Takashi Murakami. This artwork is signed and numbered by the artist on the chassis."

Buyer's Remorse

Art collector Clint Arthur visited the Murakami show at MOCA and, after taking some weeks to review the promotional brochure, purchased two of the canvases. At the time of his purchase, Arthur noticed the canvases were not numbered, even though the certificates of authenticity said they were. He nevertheless proceeded with the purchase.

Over the course of the next week, Arthur sent two letters to Murakami. The first complained about the fact that the canvases were not numbered; the second questioned whether each canvas was actually an "original artwork," as stated in the certificate of authenticity. In response to Arthur's letters to Murakami, Vuitton ultimately offered either to correct the certificates of authenticity or to rescind the sale of the canvases and return the purchase price plus interest to Arthur.

Arthur did not accept either offer and instead, in June 2008, filed a class action lawsuit against Louis Vuitton North America. At base, it appears that Arthur was driven to sue because he became convinced that the canvases were not original art, but merely scraps of canvas previously used to make Louis Vuitton goods. The case is being heard by the Federal District Court for the Central District of California.

The action essentially raises two claims under California law – first, that Vuitton had engaged in fraud in connection with the sale of the canvases, and second, that the canvases and the accompanying certificates of authenticity were in violation of California's Sale of Fine Prints Act.

After Vuitton moved unsuccessfully to dismiss the suit, what appears to have been a very contentious period of pre-trial discovery (the period during which each party discloses information about the facts of the case to the other). In one discovery-related order, the court stated, "if [Arthur] or the lawyers for either side engage in any shenanigans, this Court will not hesitate to impose sanctions." Indeed, the court did later impose sanctions in the amount of $6,000 on Arthur's attorney "to deter dubious lawyering."

In November 2009, Vuitton moved for summary judgment; in other words, it sought to have the case terminated by the court as a matter of law. The court substantially denied the motion, holding that there were sufficient issues of fact to require a trial of the case on the merits.

Was there fraud?

The court first addressed the three different statements that Arthur alleged as the basis of his fraud claim: that the canvases were authentic, limited-edition artworks by Murakami; that they were "original artworks"; and that they were autographed by Murakami.

The court held that Vuitton's failure to disclose that the canvases were made of material that Vuitton had manufactured for use in its handbags could not support a claim for fraud. Specifically, Arthur had not shown that it was misleading for Vuitton to describe the canvases as "Monogram canvases revisited by Takashi Murakami and presented in the form of editioned works" without affirmatively disclosing the exact nature and source of the material used. As the court explained, "The question in a nondisclosure case is whether the defendant knows of material facts, and also knows that those facts are neither known nor readily accessible to the plaintiff." The court said there was no evidence that Arthur could not have readily ascertained the nature of the material used for the canvases prior to purchasing them.

The court also found for Vuitton on the alleged misrepresentation that the canvases were "original artworks." The court cited Arthur's own deposition testimony that the "question of what is or is not art cannot be answered." As such, Vuitton's representation of the canvases as "genuine limited-edition Murakami artworks" was at best a "subjective" one that could not be "proven as fraudulent."

Nevertheless, the court allowed the fraud action to proceed as to the allegation that Murakami had not personally signed each canvas. The court found that a declaration submitted by Vuitton's Director of International Development of Production did not provide sufficient factual basis for a dispositive finding on the issue. The declaration stated that Murakami had conceived of the canvases and personally signed them, and included a photograph of Murakami signing the canvases. However, the declaration did not say that the Director had personally seen Murakami sign the canvases, so the authenticity of the signatures remained a question of fact for trial.

What is a "Multiple?"

California's Fine Prints Act ("FPA") requires certain information to be listed on a certificate of authenticity, including details about the process by which a "multiple" was produced. The certificates at issue here did not include that information. Vuitton argued that the FPA did not apply to the canvases because they were not multiples. The court disagreed, holding that the canvases constituted "prints" or "similar art objects" that were "produced in more than one copy." The court also rejected Vuitton's argument that the pieces were unique because they had each been hand mounted on a chassis; the court held that the chassis was not part of the artwork and noted that the California legislature probably did not intend for art dealers to be able to avoid the FPA requirements simply by mounting prints onto frames. Moreover, the court said, even if the chassis were part of the artwork itself, works with identical chassis would also qualify as multiples under the FPA definition.

What's at Stake?

Individually, if Arthur prevails on his fraud claim, he has the right to seek actual compensatory damages plus punitive and exemplary damages. Because the two canvases he purchased were among the first 50 of their respective editions, Arthur paid $6000 for each. His actual damages, therefore, are limited to $12,000. While the amount of punitive damages cannot be specifically predicted, California law requires that punitive damages bear some reasonable relationship to the harm suffered by the plaintiff who is actually before the court and not damage caused to others or society as a whole.

Under the FPA, if Arthur prevails, he is entitled to return his canvases to Vuitton and get his money back, with interest – exactly what he was offered by Vuitton in the first place. However, if he can show that Vuitton's violation of the statute was willful, he can also receive punitive damages of three times that amount – or $36,000, plus interest.

If the court ultimately certifies a class in the case (i.e., allows it to proceed as a class action), then the amount of damages at stake will be multiplied by the number of prints sold to the class members.

Lessons learned.

On a very basic level, the court's opinion demonstrates three truths that by now should be self-evident. First, like every other area of commerce, the art market is governed by laws, and it pays to know about them in advance and to comply with them. Had Vuitton included in the certificates of authenticity a description of how the canvases were produced – as required by the FPA – Arthur would not have had a colorable claim under the statute, and a significant amount of legal expense could have been avoided.

Second, one can only assume – or hope – that Murakami *did* personally sign each chassis, as represented by Vuitton, and that the failure to file a declaration from the artist to that effect to support the summary judgment motion was simply a strategic mistake. The point, though, is that if you represent to someone that something is true, make sure that it is. Period.

Three, sometimes people will bring lawsuits that seem frivolous and frustrating at first, but wind up having legal legs. A state court judge dismissed a related case brought by Arthur, calling it a "prime example" of "opportunistic litigation." The federal judge in this case referred to it in an earlier ruling as perhaps "misguided litigation." Nonetheless, it is a real lawsuit that has to be defended at real cost.

Litigation as performance art.

Setting aside the legal issues for a moment, the lawsuit itself can be seen as an acting out of the very theme of the MOCA show.

It is a rare thing for a museum to have a functioning boutique as part of an exhibition. Museums often have gift shops, but they are not usually located in the middle of the exhibition floor. The inclusion of the shop was not, however, as controversial as one might have expected. Why? Because the boutique was there as a concrete expression of a central theme of Murakami's work – an acceptance of (and enthusiasm for) the blending of art and commerce. Indeed, the theme is proclaimed in the title of the show – "©*MURAKAMI*."

The canvases that Arthur purchased in that boutique consisted of the same patterns that were on the handbags in the shop. Arthur says that he didn't know at the time of the purchase that the canvases were made from the same material as the handbags – and alleges that this means that they are not original works of art. As a legal matter, the court was right to conclude that Vuitton's failure to identify the source of the material did not constitute a basis for a claim of fraud. The information seems clearly to have been available to Arthur. It also seems that the answer to the more conceptual question – "is it art?" – was also clearly on display. In fact, it was the whole point. One can buy into Murakami's concept or not, but the show, the shop and the canvases all reflected the conflation of commerce and art that is central to the artist's work.

As of this writing, a jury trial is set for February 22, 2011. In the meantime, canvases from the exhibition have sold at auction at Sotheby's and Phillips at prices that range from $10,000 – $13,745. ❖

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The Changing Face of Artist's Resale Royalties

In February 2009, a bill was introduced in the New York State Assembly that would require the seller to pay 5% of the sale price to the artist every time a work of art by a living artist is sold in New York for $1,000 or more. The bill was referred to committee, where it remains as of the date of this issue.

The formal justification for the bill was to provide "basic protection of the rights of artists who fall at the very bottom of the economic spectrum. Very few artists are able to support themselves and their families by the income derived from the sale of their works. This will permit artists to benefit fractionally from the appreciation of the value of their works."

This rationale has informed the concept of the resale royalty ever since it was first introduced as the *droit de suite* in France in the 1920's. On first blush, it seems like a simple – and even compelling – concept. The artist who creates the work should not live (and die) in poverty while others benefit from the appreciation of his work's value. In an article published in 1972 in The Art Journal, Monroe and Aimée Price described the "theology" of the *droit de suite*:

> At its core is a vision of the starving artist, with his genius unappreciated, using his last pennies to purchase canvas and pigments which he turns into a misunderstood masterpiece. The painting is sold for a pittance, probably to buy medicine for a tubercular wife. The purchaser is a canny investor who travels about artists' hovels trying to pick up bargains which he will later turn into large amounts of cash. Thirty years later, the artist is still without funds and his children are in rags; meanwhile his paintings, now the subject of a Museum of Modern Art retrospective...fetch small fortunes at Parke-Bernet and Christie's…. The *droit de suite* is *La Boheme* and *Lust for Life* reduced to statutory form.

The use of the word "theology" in the article is apt; it connotes an article of faith that persists in the face of contrary evidence or argument. The resale royalty is an idea that has never really worked, but will not go away.

The Fundamental Flaws

The central feature of a resale royalty is that it requires a resale of a work of art. In other words, it only applies to secondary market transactions – and only a tiny fraction of artists ever make it to the secondary market. Moreover, even where an artist's work does sell on the secondary market, the overwhelming bulk of resale royalties are paid to the estates of the wealthiest and best known artists – such as Picasso and Matisse. This has to do not only with the significantly higher prices that are achieved for the works, but also with the difficulty and expense of enforcement. It costs money to enforce private legal rights – and the risk/reward analysis that any artist or estate must make before bringing lawsuit will be to compare the royalty to be received to the cost of litigation, as well as the cost of angering a collector who has no interest in adding the royalty to his bill.

Resale royalty schemes have also proven to be a questionable use of government resources. As an example, in California, the only state that imposes a resale royalty, if the seller of a work is unable after 90 days to locate the artist to whom a royalty is owed, the money is payable to the California Arts Council, which then has 7 years to locate and pay the artist before the funds are kept by the state to support a public arts program. An article in the Wall Street Journal in March 2009 outlined the Council's difficulties in disbursing the funds, describing one (presumably extreme) situation in which a state employee spent five months attempting to deliver an $80 check to an artist. A similar structure is proposed for New York.

As a result, the enforcement of the resale royalty laws is sporadic at best. Add to that the difficulty of even tracking sales in the private market – sales by dealers and by private collectors – and you get legislation that is likely to be more honored in the breach than in the observance.

The Australians take a turn.

Legislation became effective in June in Australia that aims to address these enforcement issues. Under the Australian scheme, *every* commercial sale of an original work of art (i.e., every sale in which an art market professional is involved) is required to be reported to Copyright Agency Ltd. (or CAL), a private organization designated by the Australian government to implement the legislation. The report must contain the sale date; the price; a description of the work; the title of the work; the name of the artist who created it; the artist's nationality, and whether the artist is living or dead. Where CAL deems it necessary in order to enforce payment of the royalty, it can also require the names of the parties to the transaction. Using that information, CAL determines as to each transaction whether the payment of the royalty – 5% of the sale price – is required by the statute. If it is, the seller, buyer and art market professional all bear joint responsibility for its payment.

The Australian royalty is payable with respect to (i) sales of artwork for $1000 or more, (ii) by artists who are living or have been dead less than 70 years, and (iii) who are (or were) Australian or citizens of other countries that have resale royalty legislation. In order to be paid a resale royalty, artists or their estates must be registered with CAL. Once CAL has made a determination that the royalty is payable with respect to any reported sale, it is required by the legislation to publish on its website all of the information that it has about the transaction other than the names of the parties and the sale price of the artwork. The information stays on the website for 21 days, during which time artists or their estates who have not yet registered with CAL may register and seek payment of the royalty, and artists who are already registered may decline to receive the payment. The legislation requires that artists who decline to receive the payment do so with respect to each individual transaction; CAL is not permitted to honor blanket waivers.

Where an artist declines to receive the royalty, CAL does not collect it. In all other circumstances, CAL is required to collect the royalty and to pay it to the entitled recipient. Where, after six years, CAL is unable to locate any entitled right-holders, it will attempt to repay the party who paid it. Failing that, it will retain the money to finance the administration of the scheme.

An unintended consequence?

CAL is authorized to take steps to ensure that it is receiving the mandatory reports of every commercial art transaction and to impose penalties where parties fail to make those reports. The legislation will therefore create a comprehensive record of every sale of art that goes through Australian dealers, galleries, advisors, and auction houses. In its publications about the new rules, CAL says that "as far as it is aware" it is not required to share any of the information with any part of the Australian government, including the tax authorities. Nor is it aware of any obligation on its part to disclose information pursuant to a private inquiry under Australia's freedom of information laws. But the law is new, and the possibility remains that the information may one day be used for other purposes.

Will it work?

It remains to be seen whether the Australian experiment will work and how its success or failure will be defined.

A particular focus of the Australian legislation is the population of indigenous artists – artists whose work has recently found a broader international audience. Special efforts have been made to reach these artists, including outreach to the indigenous art centers that promote their work. This particular focus may be the closest modern equivalent of the nineteenth century starving artist in a garret, in need of protection from a sophisticated market always eager for the "next new thing."

More generally, though, the underlying fairness and usefulness of a resale royalty regime has been widely questioned.

First, as noted above, resale royalties largely benefit artists for whom the market has already amply provided. That may be an acceptable result. Some recent proponents have begun to justify the need for a resale royalty by arguing that authors and musicians receive royalties when their works are published, purchased, and performed. Shouldn't painters and sculptors get equivalent treatment? Whether or not the analogy works, it is a far cry from promoting the support of unpaid and unappreciated artists.

Second, when a collector purchases a work of art, it is a statement of confidence in the particular work. Where the purchase takes place early in the artist's career, it is a statement of confidence in the artist's future – and the purchase itself may help the artist achieve that future. There is no guarantee at the time of the purchase that the value of the art will increase. If it does, it is often related to the later work of the artist himself. If his career is strong, not only will the value of his earlier work increase, but his later work will also command higher prices. If his reputation fades as he gets older – i.e., if he and his work do not stand the test of time – the prices of his earlier works will likely decline. If the artist is to be entitled to a portion of the upside, should he also share in the collector's loss if the price declines?

Finally, as a practical matter, galleries who work with emerging artists often use the proceeds of secondary market sales to subsidize their sales efforts on behalf of new and emerging artists. By diverting the funds that dealers would otherwise use to support as–yet unsuccessful artists, or that collectors might otherwise use to purchase work by those artists, the royalty may actually be counterproductive.

Each of these arguments would be less persuasive if a resale royalties scheme could be shown to accomplish its proffered goal – that is, to assist the artists "at the very bottom of the economic spectrum." Perhaps the enforcement mechanism now in effect in Australia will make a step in that direction. It will be interesting to assess its effectiveness over the next five or ten years. ❖

For more information on this topic, contact Jo Laird at 212.336.7614 or jblaird@pbwt.com.

In Fisk Litigation, Court's Solomonic Decision Proves Controversial

In the Summer 2009 issue of *The Legal Canvas* we covered a case involving the proposed sale by Fisk University of a partial interest in its Alfred Stieglitz collection. In order to improve its desperate financial condition, Fisk had sought leave of a Tennessee court to lift a donor restriction on sale of the collection so that the university could sell an undivided half-interest in the collection to the Crystal Bridges museum in Arkansas. We noted that this case would be one to watch, as it enters the debate on art deaccessioning and grapples with how an institution can honor donor intent when financial needs are pulling in a different direction. After a series of filings and interim decisions this summer and fall, the court recently issued a decision that authorizes the sale to go forward – but with unexpected limitations that have dismayed both parties and will almost certainly be appealed.

This summer the court held a trial on the question of whether Fisk had met the legal standard warranting release of the donor's restriction – in this case, primarily the prohibition on sale of the collection imposed by Stieglitz's widow, Georgia O'Keeffe, when she gave the collection to Fisk. Under the equitable doctrine of *cy pres* (an abbreviated version of the old Anglo-French phrase "*cy pres comme possible*," which means "as nearly as possible"), a charity seeking to modify the restricted purpose of a charitable gift must demonstrate, among other things, that the donor's original purpose has become "impossible or impracticable" to achieve and that the proposed modification will cure the impossibility or impracticability and "most effectively accomplish" the donor's intent.

In an opinion dated August 20, the court found that while literal compliance with the donor's specifications was "impracticable," because Fisk could no longer care adequately for the collection, Fisk's proposed modification would not most effectively accomplish O'Keeffe's intent. Instead, the court said, the proposed relief would dilute her intent to "enable the public – in Nashville and the South – to have the opportunity to study the Collection in order to promote the general study of art." The court sent the parties back to the drawing board.

The party opposing Fisk is the Attorney General of Tennessee. As the agency charged with protecting the public's interest in the proper application of charitable assets, the Attorney General has taken the position that the proposed sale departed from O'Keeffe's articulated intent to benefit the people of Tennessee. Throughout the fall the Attorney General and Fisk presented dueling proposals and critiques of each other's proposals.

On November 3, 2010, after the last round of submissions, the court issued its decision, permitting the sale to go forward, but with significant restrictions. First, the sale agreement will have to contain a number of provisions developed by the court in order to preserve donor intent and maintain the court's continuing jurisdiction over any future sale or transfer of the collection. Second, and even more significantly, $20 million of the $30 million sale proceeds will have to be placed in an endowment fund administered by a separate foundation exclusively for the benefit of the collection, with only the "income" of the fund to be paid over to Fisk for maintenance of the collection. The court directed the endowment fund to be set up in such a way that if Fisk goes out of business, the endowment may not be used for winding up costs or be reached by Fisk's creditors.

The court's decision derives from its view that it must ensure that any modification of donor restrictions adheres as closely as possible to the donor's "full dispositional design." The court made it clear that its decision was meant to honor the various elements of O'Keeffe's charitable design, which included not only benefiting the people of Nashville and the South but also benefiting Fisk specifically. The court also appears to have been concerned that Fisk might fail, even after receiving the $30 million infusion of cash contemplated by the original proposed agreement, in which event none of O'Keeffe's purposes would be served.

Fisk has objected to the decision on grounds that not nearly enough cash will be freed up to meet its current financial needs. Furthermore, Fisk has pointed out that the collection only requires about $131,000 annually in upkeep and has estimated that $20 million could generate nearly ten times that. Meanwhile, looking at the outcome of the case as representing a major deaccession by Fisk, the American Association of Museum Directors would have wanted precisely the opposite result and has issued a statement disapproving of the decision for letting any of the proceeds be used by Fisk for its general operating needs.

If $10 million is not enough to enable Fisk to survive and a $20 million endowment fund is more than Fisk needs for the collection, the court has merely postponed till another day a determination of what will ultimately happen to this endowment fund and to Fisk's share of the collection. Both sides are presently studying the decision and considering their options. ❖

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Quick Updates

Joe Simon-Whelan Drops Antitrust Suit against Warhol Foundation

In our Summer 2009 issue, we reported on an antitrust case brought against the Andy Warhol Foundation, the Andy Warhol Authentication Board, and the artist's estate and its executors. The suit was brought by collector Joe Simon-Whelan, who owns a work that the Authentication Board twice declared to be inauthentic. Simon-Whelan alleged that the Foundation and the Authentication Board restrained trade by conspiring to reduce artificially the number of authenticated Warhols on the market, and engaged in anticompetitive conduct in order to monopolize the market for the re-sale of works by Warhol. In May, 2009, a federal district court permitted the case to go forward.

In late October, Simon-Whelan announced that he was walking away from the case. He said he still believed that the work he owns is authentic, and during the course of discovery he presented supportive testimony from respected Warhol experts. He said, though, that he simply could not afford to continue the litigation against the vigorous defense of the Warhol entities.

The Warhol Foundation, however, declared that it would continue to pursue its counterclaims. At a hearing on November 10, the parties reached a tentative settlement whereby each side would drop its claims, Simon-Whelan would state that he had found no evidence of any wrongdoing on the part of the Foundation, and he would agree not to make any profit from his claims (such as from book or movie deals).

Simon-Whelan's decision to drop the case underscores the truism that litigation is expensive. And, because you can't predict what your adversary will do, you can't predict or control what the cost will be.

The decision to drop the suit also underscores how difficult it is to obtain any meaningful legal remedy against authentication committees and authors of catalogues raisonné. In our Spring 2010 edition, we discussed the case brought by Joel Thome against the Calder Foundation, established not only that authors of catalogues raisonné have no legal obligation to render any opinion on a work of art, but also that a court will not itself engage in the authentication process. That case left open the possibility that a successful cause of action could be raised against an authentication board if the plaintiff could show that the board was engaging in unlawful activity.

That, of course, is exactly what Simon-Whelan was trying to do. We will never know whether he was right or wrong, because the cost of proving his allegations came to be too high.

We will also never know what would have happened had Simon-Whelan won the lawsuit. Even if he had succeeded in proving that the actions of the Foundation and the Board were unlawful and that the denial of the authenticity of his picture was a part of that unlawful activity, it is not at all certain that the market would have accepted the picture as authentic. ❖

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NYPMIFA – New York's new rules for investment management and endowment spending

In our Spring 2009 issue, we addressed the question of "underwater" endowments and noted that the Uniform Prudent Management of Institutional Funds Act, if adopted in New York, would work significant changes by (among other things) providing greater flexibility to nonprofits in making appropriations from endowment funds.

UPMIFA is a model act promulgated by the Uniform Law Commission, applicable primarily to not-for-profit corporations. By mid-2010 it had been adopted in 46 states and the District of Columbia. On September 17, 2010, UPMIFA finally came to New York, but with unique features that present significant challenges and burdens for the state's nonprofit organizations. New York did not depart dramatically from the uniform statute in the area of investment management, where the statute updates existing law to provide a more detailed standard of care in the management and investment of institutional funds. However, the New York version of UPMIFA – known as "NYPMIFA" – does contain unique provisions concerning diversification of funds and conflicts of interest possessed by agents to whom the investment management function is delegated.

In the endowment law area, New York substantially modified the uniform statute. While UPMIFA was intended to give greater flexibility to charities by eliminating the rule that an organization could not spend below the "historic dollar value" of an endowment fund and instituting a more detailed prudence standard governing appropriations from endowment funds in its place, NYPMIFA has several features that reduce UPMIFA's flexibility or impose hurdles before an institution may avail itself of the new regime. Where the donor of an endowment fund is not available (i.e., is no longer alive or cannot be located), the organization must consider a list of eight factors before deciding to appropriate or accumulate funds and must make a contemporaneous record describing the consideration given to each factor. Where the donor of a fund is available, the organization must send a prescribed notice to the donor at least 90 days before availing itself of the new appropriation regime, essentially seeking the donor's consent to do so. For endowment funds set up after the September 17, 2010 effective date of the Act, New York adopted a presumption that an appropriation in excess of 7% of the fund in any one year (calculated as a quarterly average over a 5-year period) is imprudent. Most of the states that have adopted UPMIFA have declined to include a presumption of imprudence for new endowment funds, and none of them has included NYPMIFA's notice provision for existing funds with available donors.

For a complete description of NYPMIFA's terms, how they differ from UPMIFA, and what the new statute will mean for nonprofits in New York, please visit http://www.pbwt.com/resources/publications/new-york-version-of-upmifa, or contact one of the attorneys below. ❖

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New York Sales Tax: Risks for Limited Partners and Members of LLC's

Introduction

New York art galleries generally are required to collect and pay over to New York State any New York sales tax that arises from the sale of a work of art. Galleries that do not properly collect and remit sales tax from purchasers are directly liable for the tax, in addition to any interest and penalties.

The New York art community is no stranger to the dangers of failing to comply with New York sales tax rules. After the 2002 indictment of Tyco International's former chief executive, L. Dennis Kozlowski, for evading New York sales tax on $14 million worth of artwork, many buyers and art galleries were investigated and held liable for unpaid sales taxes.

As dealers discovered in 2002, it was not just the gallery as a corporate entity that could face liability for unpaid sales tax; the owner of the gallery and the persons responsible for the payment of taxes on behalf of the gallery could be held personally liable. A recent decision of the New York Tax Appeals Tribunal makes clear that if the gallery is organized as a limited liability company ("LLC") or a partnership, these aren't the only individuals at risk. Under the December 2009 ruling *In the Matter of Santo*, **any member** of an LLC or partnership can be held liable for the entire amount of the entity's unpaid sales tax (including penalties and interest), regardless of the member's day-to-day involvement in the company's business and regardless of the size of the member's interest in the LLC or, in the case of partners, the partner's status as a general or a limited partner.

Background

The *Santo* ruling is less a change in the law than a shift in the state's enforcement policy. The New York statute at issue could not be more clear. Any person "required to collect any [sales] tax" is personally liable for the business' unpaid sales tax. New York Tax Law Section 1131(1) defines a person "required to collect any tax" to include "any member of a partnership or limited liability company." The statutory language imposing strict liability on "any member of a partnership" has been part of Section 1131 since its enactment in 1965. In 1994, the New York State Legislature expanded the provision to include "any member of a limited liability company."

As discussed more fully below, the sales tax rule is inconsistent with the basic rules governing partnerships and LLCs. Indeed, when the rule was initially extended to LLCs, some observers though that it was so inconsistent with the purpose of an LLC as to have been a simple legislative mistake. Perhaps as a result, the New York State Department of Finance and Taxation evidently chose for a number of years not to enforce the sales tax provisions against limited partners of limited partnerships and members of LLCs. To the extent that the more lenient enforcement policy was a deliberate one, the Department has clearly changed its mind.

The *Santo* Decision

In 2004, Joseph P. Santo and two other individuals formed a New York LLC to operate a restaurant. Mr. Santo, who primarily oversaw the management of the restaurant staff, contributed nothing to the LLC in exchange for his interest in it (which ranged over time from one third of the LLC to less than one quarter), was not in charge of the company's financial operations and was not responsible for filing any LLC tax returns. The restaurant eventually failed and bankruptcy proceedings for the LLC were commenced in

2006. New York State subsequently assessed Mr. Santo for the LLC's unpaid sales taxes, totaling almost $200,000 (including interest and penalties).

In March of 2009 a New York Administrative Law Judge ("ALJ") held Mr. Santo not liable for the LLC's unpaid sales because he "lacked the power to exercise the tax collection responsibilities on behalf of the LLC." The ALJ stated that Mr. Santo was "not an investor, was not involved in the day-to-day operation of the restaurant and was not responsible for the financial management of the business."

The ALJ did not address the statutory provision that imposes strict liability on members of LLCs and applied instead a different provision that holds the officers and employees of a business (whether organized as a partnership, corporation or LLC) personally liable for the business' unpaid sales tax if the officer or employee is "under a duty to act" for the business in complying with the applicable provision of the tax law. After finding that Mr. Santo was not under such a duty to act for the LLC, the ALJ cancelled the Department's assessment against him for the restaurant's unpaid sales taxes.

Mr. Santo's success was short-lived. In December of 2009 the New York State Tax Appeals Tribunal reversed the ALJ decision, ruled that the ALJ applied the wrong standard to Mr. Santo, and held him strictly liable for all of the LLC's unpaid sales taxes by reason of his status as an LLC member:

> Petitioner was a member of a limited liability company and, as with members of a partnership, such members are subject to per se liability for the taxes due from the limited liability company. Since Tax Law Section 1131(1) imposes strict liability upon members of a partnership or limited liability company, all that is required to be shown by the Division for liability to obtain is the person's status as a member.

The *Santo* case is the first reported decision of the Tribunal that reflects the Department's shift in enforcement policy.

A striking anomaly.

Enforcing *per se* liability may result in the collection of more sales tax, but the rule is inconsistent with the general New York law governing limited partnerships and LLCs, the rules governing other "trust fund" taxes such as federal and state withholding taxes on wages, and rules governing the liability for sales taxes of officers or employees of corporations. The New York State Bar Association, as well as tax practitioners have called for a change in the law; as of the date of this article, the New York Legislature has failed to act.

Partnership and LLC Law. The *sine qua none* of limited partnership law is the limitation on personal liability of an investor who does not participate in the management of the partnership. Similarly, under the New York State Limited Liability Law a person cannot be held personally liable for an LLC's debts "solely by reason" of the person's status as an LLC member. The imposition of personal liability for unpaid sales taxes on limited partners and LLC members is an anomaly, wholly at odds with the usual treatment of LLCs, limited partnerships and the those who own them.

"Trust Fund" Tax Regimes: The strict liability rule is also at odds with the rules governing other "trust fund" taxes. "Trust fund" taxes are taxes primarily imposed on one party, but collected and paid over to the government by another party. For example, federal and state taxes on wages are collected by an employer by withholding money from its employee's wages and then paying it over to the government. Sales taxes are considered "trust fund" taxes because the tax is primarily imposed on the purchaser of goods, but is collected and held by the business "as trustee for and on account of the State." Businesses (including art galleries) that fail to collect and pay over sales tax are liable for the tax, as well as interest and penalties.

"Trust fund" tax regimes typically impose personal liability only on "responsible persons," that is persons involved with a company's business and responsible for collecting the tax and paying it over to the government. For example, federal law imposes personal liability for unpaid federal withholding taxes (plus interest and penalties) upon persons required to collect, truthfully account for, and pay over the tax, who willfully attempt in any manner to evade or defeat it or the payment of it to the federal government. With respect to LLCs and limited partnerships, the IRS has ruled that it will impose personal liability on their partners and members for unpaid federal withholding taxes on wages only when the person is generally liable under state law for the debts of the entity. With respect to employment tax withholding, New York closely follows the federal rules and generally imposes personal liability for the failure to collect employment taxes only on "responsible persons."

The New York and federal rules imposing personal liability on "responsible persons" for employment withholding taxes make equitable and intuitive sense. After all, persons involved in the day-to-day business will have the relevant knowledge to ensure compliance and generally will be in a position to control the collection and payment of the tax. As intuitive and equitable as it may be, however, it is not the law when it comes to New York State sales tax.

Arcane laws can have surprising consequences.

Any number of dealers and galleries may be organized as limited partnerships or LLCs. These forms of organization have benefits that may suit the particular business (or portion of a business) of the gallery. However, galleries that have passive or minority investors or partners may want to revisit their corporate structure in order to protect those individuals. Investors in galleries or other art-related LLC's may want to consider restructuring how they support the gallery – perhaps, for example, shifting from being a limited partner or LLC member to being a creditor. Alternatively, passive or minority investors and partners may want to consider requiring the gallery to certify periodically that all sales taxes have been duly paid. Absent legislation from Albany, these sorts of measures may be the only way to limit what could otherwise be substantial liability. ❖

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On the Cover

The cover art for this issue is a work by Ingrid Calame, *Arcelor Mittal Steel Shipping Building One*, *No. 233, 2009*, oil on aluminum, 40 x 24 inches. The artist began the work by tracing markings and painted numbers on a shipping dock floor in a former steel plant in Buffalo, New York. The numbers had been used by operators of cranes to locate rolls of steel. Through Calame's process of tracing the leftover and the unnoticed, she creates abstractions that have a strong connection to concepts of history and loss. At the same time, her paintings are vibrantly colorful. Calame's work is included in the permanent collections of the Los Angeles Museum of Contemporary Art, the Museum of Modern Art, the Whitney Museum of Art, the Indianapolis Museum of Art, the Museum of Fine Art, Houston, and the Albright-Knox Art Museum, among others. She is represented by the James Cohan Gallery in New York.

The Legal Canvas is a free newsletter prepared by attorneys in the Art and Museum Law Group of Patterson Belknap Webb & Tyler LLP for our clients and other interested friends.

This newsletter is for general informational purposes only and should not be construed as specific legal advice. If you have any questions about any of the articles in *The Legal Canvas* or wish any further information, please contact any of the following attorneys:

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