The Legal Canvas

Spring 2009

Patterson Belknap Webb & Tyler LLP

1133 Avenue of the Americas New York, NY 10036-6710 212.336.2000 www.pbwt.com

Welcome

We are pleased to welcome you to the first edition of *The Legal Canvas*, a publication of the Art and Museum Law Group at Patterson Belknap Webb & Tyler LLP.

The purpose of *The Legal Canvas* is to report developments in the field of art law in a way that is user-friendly and practical — whether you are a collector, an artist, a museum trustee or employee, a gallerist, or an art adviser.

In this first newsletter, for example, we address two issues that are facing museums and their trustees in the current economic downturn. First, we suggest ways to deal with the legal constraints on spending money when an institution's endowment funds are "underwater." We also consider the ethical constraints on selling art to raise operating funds and how those guidelines are being tested in the current economy. Also of interest to museums and other exempt organizations is a report on a change in New York State's sales tax rules that eliminates certain advantages these organizations have enjoyed in the past.

On other fronts, we outline the new regulations governing the import of certain works of art from China and describe recent litigation against art authentication committees. You will also find a description of a recent Federal Court decision that may broaden the availability of U.S. courts to Holocaust restitution claims. Finally, we address the copyright dispute between Shepard Fairey and the Associated Press over the Obama "Hope" poster and compare it to another recent case involving "appropriation" art.

We hope that these articles will provide you with useful general guidance. We also hope that we will have the opportunity to work with you on your art-related legal issues. Our group is made up of lawyers with extensive experience in the art world and the art market. We provide our clients with advice on art transactions, gifts of artwork, estate and tax planning, intellectual property, the governance and tax issues of museums, private foundations and other types of tax-exempt organizations, real estate, employment, employee benefits and dispute resolution and litigation. ❖

Experienced art world professionals.

The resources of a full service firm.

In this issue . . .

Cover Artwork ©1990 Elliott Arkin

Downturn and Deaccession

It is not surprising that the economic downturn has brought back the deaccession debate. Museums, colleges and universities have been hit with the one-two punch of watching their endowments shrink, while at the same time losing many of their major donors who themselves have been hit by the market and perhaps by Mr. Madoff. The current economic situation has made real what in many cases before may have been mere hyperbole – that the sale of art could be crucial to the continued existence of an institution.

Nevertheless, the decision to sell art to pay the costs of operations has serious repurcussions for a museum. The American Association of Museums, the Association of Art Museum Directors, as well as other professional organizations, subscribe to a fundamental ethical rule that an art museum must use the proceeds from selling (or "deaccessioning") art only for the purchase of other art. The rule serves the important purpose of protecting a museum's collection against the temptation to sell art to close a budget shortfall, build a new wing, or fund an ancillary program. The temptation is there in good times and bad; art may be able to generate a large amount of money very quickly, and boards may see the sale of art as less disruptive than, for example, terminating staff or making other cutbacks. The museum associations have defended the deaccession rules vigorously, because they see the slope as treacherously slippery.

But these are not just bad times. They are, by many accounts, terrible times. And the current discussion has brought some interesting turns.

1. College Museums. In January, Brandeis University announced that it would close its highly-regarded Rose Museum, and sell the Rose's large and distinguished collection. As the situation unfolded, however, Brandeis officials made clear that their intent was not to sell the collection, but to change the museum building into a space for a reconfigured arts program – a move that was apparently meant to simplify the sale of art in the future should Brandeis choose to do so. As senior University officials conceded shortly after the announcement, it was their understanding that as long as the museum was in operation, the sale of *any* art would be complicated. In other words, it appears that the decision to close the museum (reportedly self-sufficient and a source of net revenue for the University) may have been driven by the perceived need to break free of the ethical restraints prescribed by the museum associations. Most recently, Brandeis has formed a special committee to study the future of the Rose.

The situation at Brandeis is a work in progress and the outcome could have a significant impact on museums at other colleges and universities. Regardless of the outcome, however, the events themselves may already have had a chilling effect on the donation of art to campus museums.

Campus museums have their own mission, but they are also necessarily part of the larger educational mission of a college or university. The events at Brandeis have underscored that fact – and may have led some collectors to conclude that art donated to a campus museum is at greater risk of deaccession than work donated to a stand-alone museum. This will not be a concern for a donor whose primary purpose is to aid the college or university. But, for a donor who wants his art to remain part of a museum collection, it could be a highly significant factor.

Donors may ultimately choose to protect their intentions by imposing restrictions on their donations — a measure that historically has not been favored by museums, which have a legitimate interest in preserving their institutional flexibility. The recent events at Brandeis may mean that donors and museums, especially campus museums, will be spending more time than ever trying to craft restrictions that accommodate the needs of all concerned.

2. Legislation. New York State Assemblyman Richard Brodsky, a graduate of Brandeis University, has introduced legislation that would regulate deaccessioning by museums in New York State. Under the bill, proceeds from deaccessioning could be used only to acquire more works for the collection or for the preservation, protection and care of the collection. The legislative findings set forth in the bill note that the current economic situation has led to increased pressure on museums, and that there have been attempts to "monetize" collections. Those attempts, according to the bill, "are inconsistent with…accepted museum practices, and, if left unchecked, will permanently endanger the integrity and existence of museum collections handed to us by earlier generations as a sacred cultural and ethical trust." This bill follows an unsuccessful attempt in December by the New York State Board of Regents (which oversees museums chartered after 1889) to promulgate rules that would have permitted museums regulated by the Regents to use the proceeds of the sale or transfer of art to another museum or historical society to pay debts in order to prevent bankruptcy or liquidation. The Regents pulled back from the policy after strong protests were lodged by museum professionals, but have reserved the right to revisit the issue.

3. AAMD Censure and Consultation. In December, New York's National Academy sold two Hudson River School paintings to raise money for operating expenses. The AAMD, then censured the institution and asked the AAMD members to cut off loans and discontinue all collaborations with the National Academy. In March, *The New York Times* reported that representatives of the AAMD and the National Academy had met and that the National Academy had promised to sell no more paintings and to implement better financial management and a reconfigured board of directors. The head of the AAMD described the meeting as "a step in the process of re-engaging the academy as a member in good standing." ❖

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

Holocaust Restitution: Will a Recent New York Case Open the Door to a Wider Set of Claims?

Over the past decade, the number of art restitution claims in U.S. courts involving transfers of works of art with Nazi-era provenance has increased dramatically. These suits often pit innocent parties against one another. On the one hand, the claimants are heirs of Holocaust victims and may have learned only recently that their deceased relatives owned the works in question. On the other hand, the current holders of the art are usually good-faith purchasers who paid full value for their purchase, had no knowledge of the art's Nazi-era provenance, and now must defend their title against claims involving actions taken more than 60 years ago in foreign countries during times of war and massive upheaval. In many cases, the documents that would show whether or not title passed legitimately have been lost, the witnesses to the suspect transactions are no longer living, and the works of art have passed several times among numerous owners in multiple foreign jurisdictions.

U.S. courts can be attractive places to bring art restitution claims. The substantive law of property transfers in the United States favors original owners over good-faith purchasers. Under U.S. law, a thief can never pass good title — even to a good-faith purchaser. Moreover, if the first good-faith purchaser sells to a second good-faith purchaser, the second purchaser also does not obtain good title (because the first good-faith purchaser never had 'good title' to sell). And so on. This means that, under U.S. law, an original owner can bring a claim against any subsequent holder of a stolen work of art. By contrast, in most European jurisdictions, after the passage of a specified number of years, good-faith purchasers obtain good title to artworks, regardless of whether the works were originally purchased from a thief.

A key issue, then, in many Holocaust era claims is what law will be applied to the facts by the court. This year, in a Federal case in New York — *Schoeps v. The Museum of Modern Art and the Solomon R. Guggenheim Foundation* — Judge Jed Rakoff applied New York law to the question of whether a good-faith purchaser had good title to a work of art alleged by the plaintiffs to have been sold under duress in Switzerland during the Nazi-era.

At issue in *Schoeps* were two works by Pablo Picasso, *Le Moulin de la Galette* (1900) in the collection of the Guggenheim and *Boy Leading a Horse* (1906) in MoMA's collection. The paintings had been the property of the Jewish art collector Paul von Mendelssohn-Bartholdy, Schoeps' great-uncle. The museums claimed that in 1927, Mendelssohn-Bartholdy gave the paintings at issue to his wife, Elsa, who was not Jewish, and that Elsa subsequently sold the paintings to Justin K. Thannhauser in 1934 or 1935. Thannhauser, in turn, donated *Le Moulin de la Galette* to the Guggenheim in 1963 and sold *Boy Leading a Horse* in Switzerland in 1936 to the American collector William S. Paley. Paley donated *Boy* to MoMA in 1964. Schoeps claimed that the transfer of the paintings to Elsa and their subsequent sale were made under duress and were therefore invalid.

Focusing on the sale of *Boy Leading a Horse*, the museum defendants claimed that because the painting was sold to William S. Paley in Switzerland, Swiss law — under which Paley's presumably good-faith purchase would by now have resulted in good title — should apply to bar the claim. The court disagreed. First, the judge noted that New York's conflict of laws analysis is an "interest analysis" — i.e., the law of the jurisdiction with the greatest "interest" in the outcome will apply. While acknowledging that this analysis would often lead to the application of the law of the jurisdiction where the transaction occurred, the court said that this was not always the case. Here, while the picture was purchased in Lucerne, it was paid for with a check from a New York bank; it was shipped immediately to New York; and

it remained in New York for the next 70 years, where it was currently owned by an important New York institution. By contrast, the picture was in Switzerland only for the purpose of being sold, and none of the people who may have owned the picture at the time of its sale (Mendelssohn-Bartholdy, his wife or Thannhauser) were Swiss residents or citizens. Therefore, the court concluded that New York had the greater interest in having its law apply to the question of whether or not the Swiss transfer was valid. Under New York law — unlike Swiss law — the claim to the picture was not yet extinguished, permitting the case to go forward.

The *Schoeps* decision is also notable for another reason. In order for the case to be permitted to go to trial, the claimants had to provide some evidence to support their factual allegation that Mendelsohn-Bartholdy and/or his wife parted with the pictures more than 70 years ago under duress, which, under German law, would make the transfer void. The court set a fairly low bar for the sort of evidence that needed to be produced.

> "While the record regarding the transfers of these Paintings is meagre, it is informed by the historical circumstances of Nazi economic pressures brought to bear on "Jewish" persons and property, or so a jury might reasonably infer…"

Stated in this way, the *Schoeps* court seems to have applied a presumption that any transfer of property that involved a Jewish person in Germany during the Nazi-era is *per se* suspect. If context itself is allowed to substitute for specific factual evidence, a Holocaust heir may not need to produce much other than general historical background in order to have his case tried on the merits.

At trial, of course, a claimant will have to prove his case. But trials are both expensive and risky — especially where hard evidence may be hard to come by for either side and a jury may be inclined to err in favor of compensating the heirs of victims of Nazi persecution.

On the eve of the scheduled trial in early February of this year, the parties settled the matter; each museum will retain its respective painting, and pay the plaintiffs an undisclosed sum. In an unusual statement, the judge expressed disappointment, saying that it was "extraordinarily unfortunate that the public will be left without knowing what the truth is," and suggesting that he might consider ordering the specific terms of the settlement to be made public. On March 6, he entered an order instructing the parties to submit letters setting forth any reasons why he should not do so.

While the museums agreed to the publication of the terms, the plaintiffs did not. In an order dated March 23, the judge reproached the plaintiffs for insisting that the settlement terms remain secret "for reasons wholly unexplained and seemingly no more compelling than concealing the amount of money going into their pockets."

> "The fact that the plaintiffs, who repeatedly sought to clothe themselves as effectively representatives of victims of one of the most criminal political regimes in history, should believe that there is any public interest in maintaining the secrecy of their settlement baffles the mind and troubles the conscience."

Stating that he was constrained by the law of the Second Circuit to keep the settlement terms confidential unless all parties agreed to their disclosure, Judge Rakoff nevertheless said he would keep a copy of the settlement agreement filed under seal, hoping that the plaintiffs will agree to unseal it,

(Continued on page 8)

Art Authentication Committees Attract Lawsuits

Is that Warhol on your wall really a Warhol? Says who?

Unless it was the Andy Warhol Art Authentication Board, you may run into trouble if you try to sell the work. The Board, like similar bodies that exist for artists such as Basquiat, Calder, Lichtenstein and others, is generally accepted by the art market as the essential arbiter of artistic authenticity. These committees offer to opine on the genuineness of pieces put before them, claiming absolute discretion in the making of such judgments and closely guarding their procedures.

That discretion and independence arguably are crucial to the operation of the committees. Ideally, each committee member should be free to exercise his or her best judgment in assessing the authenticity of a work without having to worry about legal consequences.

But authentication committees wield extraordinary power in the art market. They can make a work salable and add millions to its value (or devalue it altogether) simply by affirming that the piece is (or is not) genuine. As questions arise about whether committee members are independent or whether they have taken appropriate care in making their determinations, it is not surprising that the authentication committees occasionally find themselves facing bad press and increased litigation. The committees are thus in the position of exercising tremendous power, while simultaneously facing greater potential liability for their alleged misuse of that power.

Three pending cases highlight some of the issues these matters raise. In one case, Patterson Belknap has filed suit on behalf of a collector against the authentication committee of a major contemporary artist to ask that the committee abide by its previous agreement to opine, one way or the other, as to whether a work owned by the collector was authentic. As alleged in the complaint, "the Committee arbitrarily refused to express an opinion" despite the collector's having submitted copious documentation and provided the work for the committee's physical examination. Absent an opinion, the complaint sought $5 million in damages, reflecting the market value of a comparable authenticated work.

In another case, Patterson Belknap is representing a New York gallery in federal court in its suit against the foundation of a prominent deceased artist. The gallery alleges that the foundation effectively withdrew, for no clear reason, a work's certificate of authenticity two years after issuing it. The gallery also alleges that the foundation has described as inauthentic several pieces that it had previously reviewed but expressed no doubts about when the gallery so inquired. The judge is currently weighing the foundation's motion to dismiss the case.

Authentication committees are also watching a case now pending in a Federal court in Manhattan against the Andy Warhol Foundation for the Visual Arts. The plaintiff, Joe Simon-Whelan, filed a class-action antitrust complaint against the foundation based on its refusal to authenticate a work that its members are alleged to have earlier endorsed as genuine. In seeking hundreds of millions of dollars on behalf of the class, Simon-Whelan claims that the foundation has for 20 years refused to authenticate genuine Warhols in order to drive up the value of works owned by its members.

Regardless of how these lawsuits are resolved, there is no doubt that authentication committees will continue to play a valuable role: the art world has a clear interest in having educated, experienced experts opine on authenticity. The system works, however, only if the market can trust that such opinions are developed with diligence and care. At a minimum, that includes considering all available

information with an open mind, expressing an honest opinion, and reversing a prior opinion only for a specific, justified and discreetly communicated reason.

From a collector's point of view, the best advice in approaching an authentication committee is to *be thorough*. A collector in need of a certificate of authenticity should provide the authentication committee with comprehensive documentation. The collector should also be prepared to offer complete records of ownership, exhibition, previous opinions on authenticity, photographs (of the work *in situ* in your collection or the collection of prior owners), and the like. In most cases, the committee will insist that the work be made available for the committee's in-person inspection. All of these steps are necessary in order to give the committee the opportunity to provide a fully informed, reasoned opinion as to whether the piece is genuine. ❖

For more information on this topic, contact
Hugh Freund at 212.336.2370 or hjfreund@pbwt.com.

Holocaust Restitution: Will a Recent New York Case Open the Door to a Wider Set of Claims?

(Continued from page 6)

after they "have had a greater opportunity to reflect on their public responsibilities, not just to the courts of the United States that have made judicial processes so freely available to them, but to the public generally."

****

It is not yet clear what effect the *Schoeps* opinion will have on subsequent Holocaust cases. It might be read as the decision of a judge who may have stretched in order to try a case that he felt was of public interest and importance — and therefore an anomaly that other judges may not feel obliged to follow. It may be that the choice of local law will be limited to circumstances involving local museums — with the thought that it is the institutional presence in New York that shifts the balance of interests in that direction.

It will be up to future litigants to test the limits of the decision, and the process has already begun. Since the *Schoeps* opinion was handed down, a claimant in a separate Holocaust restitution case — *Bakalar v. Vavra & Fischer* — has appealed a prior decision that Swiss law applied to the transfer at issue in that case. ❖

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

What Does it Take to Get Art Law Discussed on the Colbert Report?

On February 12, David Ross, the former director of SFMOMA and current director of the Albion Gallery in New York, faced off against intellectual property lawyer Ed Colbert, on a show that rarely takes on arcane questions of art law: The Colbert Report. The topic was the dispute between Shepard Fairey and the Associated Press about whether Fairey infringed the AP's copyright when he used an AP photograph in his "HOPE" poster that became an emblem of Barack Obama's presidential campaign.

The Fairey case has brought popular attention to an issue that is familiar to contemporary artists and their lawyers — that is, when does one artist's use in his own art of an image created by another artist constitute copyright infringement? Fairey admits using the AP photo of Obama to create his poster, but claims that his work is a fair use of the photograph, and therefore falls into an exception to the copyright laws.

To establish that his use of the photo is "fair," Fairey will ultimately have to establish that it satisfies one of the purposes of the fair use doctrine, i.e., that the new use comments upon or criticizes the original work; that it constitutes news reporting, teaching or scholarship; or that the re-presentation of the image changes its meaning in such a way as to advance the human "conversation." Each of these uses might be referred to by the courts as "transformative." In evaluating the fair use defense, courts will also consider whether the use is commercial or is for nonprofit or educational purposes; the nature of the copyrighted work (whether the copied work is creative or is a work of fact); whether the person claiming fair use has used more (quantitatively or qualitatively) than is necessary to achieve his purpose; and whether the second use deprives the copyright owner of a potential market for the original work or supplants its use.

Fairey claims his use is transformative because he has used the photo for a new purpose and given it new meaning. In its answer, the AP disputes the idea that Fairey's use is transformative, describing Fairey's artistic process as "a form of computerized 'paint by numbers'" and arguing that Fairey's work does not employ the AP photograph for a different purpose because it conveys only the narrative and impression that was already present in the underlying image.

Fairey has a well-established pattern of using other artists' art in his works. He is not the only contemporary artist who does it. Two of the leading cases in the area involve works by Jeff Koons; he lost the first case (as well as three unreported cases), and won the second. Richard Prince is another.

Prince is a defendant in a current case that has not made it to cable television. The case was filed in January by Patrick Cariou, a French photographer, in Federal Court in Manhattan. In his complaint, Cariou alleges that Prince infringed his copyright in published photographs of Rastafarian culture by reproducing, adapting, distributing, and displaying them without permission in Prince's paintings in his recent "Canal Zone" show at the Gagosian Gallery. Prince created the "Canal Zone" paintings by incorporating reproductions of Cariou's photographs (with some alterations by Prince) into Prince's painted images. The complaint also names the Gagosian Gallery and Rizzoli, the publisher of the show's catalogue, as co-defendants.

Like Fairey, Prince has a long and controversial history as an appropriation artist, collecting others' photographs and then incorporating them into his own work. His photographs of photographs often provoke discussion of where the underlying photograph ends and Prince's work begins. Even Prince has

said that he sees no difference between his photograph collection and his works of art. His body of work, for example, includes a photograph of Gary Gross's photograph of a nude 10-year old Brooke Shields, for which Gross sued Prince for infringement (they settled out of court). (Ironically, the text for the catalogue for "Canal Zone" was written by author James Frey, who experienced his own authoring controversy when it was revealed that he fabricated portions of his memoir, "A Million Little Pieces.")

In his answer to the complaint, filed on March 3, 2009, Prince admits that his use of Cariou's photographs was unauthorized but claims the use was "appropriate under applicable law," presumably signaling his intent to mount a "fair use" defense. A similar answer was filed by Gagosian.

The issue in these cases is not the quality of the art. Prince's use of Cariou's photographs created compelling works of art. Fairey's use of the Obama photograph created an iconic image. The question is when one artist may use images created by another without their permission, without compensation, and without crediting the original artist. The Prince case is similar to an infringement suit filed by photographer Lauren Greenfield against appropriation artist Damian Loeb who used Greenfield's photograph "*Mijanou and Friends from Beverly Hills High School on Senior Day, Will Rogers State Park*." Loeb appropriated the foreground of Greenfield's photograph, juxtaposed it with another photojournalist's painting of an execution scene in South Africa, and then painted the resulting image with photographic accuracy, calling the work "*Sunlight Madness*." Greenfield sued in 2001, Loeb claimed fair use, and the case settled. Loeb admitted infringement, paid a settlement fee, re-titled the work to reflect his use of Greenfield's photograph, and the owner of the infringing work agreed to accompany any public display of *Sunlight Madness* with a disclosure that Greenfield's photograph was the basis of the work, and that it was first published in Greenfield's book, *Fast Forward: Growing Up in the Shadow of Hollywood*.❖

For more information on this topic, contact
Gloria C. Phares at 212.336.2686 or gcphares@pbwt.com.

New Restrictions on Importing Chinese Antiquities

Collectors of Chinese art and antiquities should take note of a recent agreement that might complicate the acquisition of such works in the United States. According to a Memorandum of Understanding that the outgoing Bush Administration signed with China, various Chinese works dating from 75,000 B.C. to 907 A.D., as well as monumental sculpture and wall art dating to 1759, can no longer be imported into the United States without certain documentation. The affected works include ceramic vessels, jade ornaments, stone sculpture, musical instruments, bronze items, silks, lacquer, coins and paintings. The buyer of such a work to be shipped into the United States must now provide one of the following:

- A certification from the Chinese government that the piece in question was exported from China legally; or
- Sworn statements from both the buyer and seller that the work was exported from China on or before January 16, 2009; or
- Sworn statements from both the buyer and seller that (1) the work was exported from China at least 10 years before its importation into the United States, and that (2) the buyer did not contract to buy the work more than one year before its importation into the United States.

If the buyer has not produced such documentation by the time the piece arrives in the United States, customs agents may hold it for 90 days or more at the buyer's expense. If the required documentation still is not provided by then, the work is subject to seizure and forfeiture.

The scope of the new restrictions is considerably more narrow than the Chinese government would have liked. China's original Mou request would have affected artifacts created as recently as 1911.

The new regulations are in addition to, and do not supplant, prior law regarding the importation of cultural property, including cultural property from China, into the United States. If, for example, the work was stolen from a Chinese museum, public monument or similar institution after November 28, 1989, it cannot be imported into the United States regardless of the documentation the buyer generates. And acquisition of a work that was wrongfully obtained from its prior owner — museum or not — might lead to criminal penalties in addition to sanctions for violating the import laws. As a Federal appeals court in New York cautioned in 2003 when it affirmed an art dealer's 33-month sentence for trading in stolen works, "[i]t may be true that there are cases in which a person will be violating both the [import regulations] and [laws against dealing in stolen works] when he imports an object into the United States. But it is not inappropriate for the same conduct to result in a person being subject to both civil penalties and criminal prosecution."

Although the new regulations apply only to works being imported into the United States, sellers of pieces already located in the United States are well advised to gather the documentation described above so that, in the event they or their heirs ever want to sell the property, they can dispel any doubts a buyer might have as to the mobility and marketability of the works. In addition to the sworn statements themselves, such documentation should be as comprehensive as possible, including bills of sale, previous import or export documents, catalogues of gallery or museum exhibits (or auction catalogues) in which the property might have been included, and all other material that reflects provenance. ❖

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

Underwater Endowments: Understanding Your Options Under New York Law

With world financial markets down dramatically, museums and many other cultural organizations are facing difficult questions about what they can and must do with endowment funds that are now "underwater." Because underwater endowments are now a widespread problem in the nonprofit community, we thought readers of *The Legal Canvas* might find it helpful to have a brief outline of the available options.

This article has been adapted from a more comprehensive article posted on the Tax-Exempt Organizations section of the Patterson Belknap website. To read the longer article visit http://www.pbwt.com/resources/publications/.

Identifying Underwater Endowment Funds. Under New York law, the term "endowment fund" refers to each particular fund in the organization's investment portfolio that is not "wholly expendable . . . on a current basis" due to donor restrictions. Usually the term refers to a fund set up by a particular gift instrument, though at times it could refer to a specific fund set up by the organization that is funded by multiple gifts from different individuals. Generally speaking, an endowment fund is said to be "underwater" when its value is less than at the time of original funding. In New York, that original value is known as the fund's "historic dollar value" (sometimes referred to in this article with the shorthand "HDV").

Options Available When An Endowment Fund is Underwater. New York law sets forth rules governing how charities must account for and report on their endowment funds as well as the circumstances under which net appreciation of an endowment fund may be spent. However, the law provides little guidance on what can be done when a particular endowment fund is underwater. Here are four options available to cultural organizations and other charities that find themselves in that situation:

Option 1 — Expend Fund Income (and Only Income)

When the Endowment is Underwater Due to Asset Depreciation. A charity may not apply its endowment spending rate to an underwater endowment fund. However, a charity may *always* spend the fund's income — that is, interest, dividends, and other classic forms of income such as rents and royalties — if three conditions are met: (a) if the gift instrument does not prohibit spending income when the fund is underwater, (b) if the fund is underwater due to asset depreciation rather than appropriations that dipped into historic dollar value, and (c) if the expenditure of the income meets the applicable standard of prudence.

When Appropriations Have Caused the Endowment To Dip Below HDV. The ability to spend income from an underwater endowment fund is less assured if the fund is underwater due to appropriations that dipped into HDV (e.g., on account of the way the charity's endowment spending policy had been applied). In that situation, the New York Attorney General has said that the organization has an "affirmative duty" of restoration and has cautioned that failure to make the restoration "may subject" the board to liability for breach of the duty of care (i.e., imprudence). Due to the Attorney General's statement, an organization with an endowment fund that is underwater due to appropriations of HDV, rather than asset depreciation, might wish to discuss the matter with legal counsel, and possibly the Attorney General, before spending fund income.

Option 2 — Expend Appreciation Appropriated While the Endowment Was Above Water

There is a distinction under New York law between the *appropriation* of net appreciation and its *expenditure*. If the board has properly *appropriated* net appreciation, the charity appears to have the

ability to expend this appreciation even if the endowment fund drops below its HDV before the funds have been spent, so long as the expenditure is prudent at the time it is actually made. Charities should be aware that not all types of appreciation are available for appropriation: specifically, unrealized appreciation on non-readily marketable assets may not be appropriated.

Option 3 — Seek the Donor's Permission to Release or Modify the Endowment Restrictions

If a charity determines that it requires greater access to an endowment fund than the terms of the applicable gift instrument permit, it may wish to approach the donor and make a case for the donor's release or modification of the restrictions. The release could come in the form of permission to spend the endowment in its entirety or could be more limited. Any such release should be prepared with assistance of legal counsel.

Option 4 — Seek Judicial Release of Endowment Restrictions

For a charity seeking access to underwater endowment funds, a fourth option — which is available only when the donor is dead, disabled, impossible to identify, or unavailable — may be to initiate a proceeding for judicial relief. In such a proceeding, the charity could seek permission to spend or borrow a specific amount from an underwater endowment fund, or it could seek permission to apply the organization's spending rate to the fund, even though that would drive the fund further underwater. The need for relief of this type could become critical if endowment funds remain underwater for several years running, as can happen in a prolonged economic downturn. The process of obtaining judicial relief from the restrictions on an endowment fund can be time-consuming and expensive and, generally, should be viewed as an option of last resort.

Advice for Boards

It is an understatement to say that charities are facing difficult choices when it comes to their endowment spending decisions. Current New York law does not make it easy for boards to obtain relief from their endowments for financial exigencies. Many states have enacted a new statute, known as UPMIFA or the Uniform Prudent Management of Institutional Funds Act, designed to make their endowment laws more flexible. Discussions are under way in New York about whether it, too, should adopt UPMIFA. But the timeline for adoption is highly uncertain. Regardless of the direction that New York law takes, we offer three core principles that we believe will stand museums and other cultural organizations in good stead:

First, the gift instrument is paramount. Charities should always look at the gift instrument first because it determines what steps an organization may take without seeking approval in advance by the donor or a court.

Second, boards must remain aware that, in exercising their fiduciary duties, they always operate within the constraints of the prudence standard. Thus, even if a gift instrument permits a particular expenditure, the board may not make the expenditure unless it is prudent.

Finally, good process remains the best protection against legal liability. Although process alone may not be a sufficient condition for prudence, adequate process provides a bulwark against later objections that a particular decision was imprudent by enabling boards to demonstrate that they were informed, that they considered the relevant alternatives, and that they arrived at their decisions collectively and by means of disinterested deliberation. ❖

For more information on this topic, contact John Sare at 212.336.2760 or jsare@pbwt.com.

New York State Eliminates Some Sales Tax Advantages for Exempt Organizations

New York law exempts certain types of organizations (such as nonprofit charitable, educational and religious organizations) from the payment of sales tax on their purchases and from the collection of sales tax on certain sales by such organizations. Recent changes in the law, however, have considerably increased the situations in which such organizations must collect sales tax on their sales of tangible personal property such as books, jewelry, furniture and art.

Sales Outside a Shop or Store

Prior to September 1, 2008, retail sales of tangible personal property by qualifying exempt organizations generally were subject to New York sales tax only if the sales were made at a physical shop or store.

As of September 1, 2008, sales of tangible personal property by exempt organizations through remote means (such as telephone, mail order, e-mail and the Internet) and delivered within New York became subject to New York sales tax if such sales were made with a degree of regularity, frequency and consistency, *regardless of whether the organization also makes taxable sales from a shop or store*.

As of January 1, 2009, if an exempt organization operates a shop or store and also makes retail sales of similar items of tangible personal property by any other means (including remote means or at an auction), the sales by such other means are considered to be made from the organization's shop or store if received by the purchaser or delivered within New York and, therefore, subject to sales tax, *regardless of the frequency of such sale*s.

Sales at Auctions Run by the Organization

As of January 1, 2009, qualifying exempt organizations may hold their own "traditional auctions" without charging sales tax if they hold no more than two auctions each year, and if the things they are selling are not similar to the items that are sold in their shops or stores. A traditional auction is one at which bidders or their representatives are physically present, regardless of whether bids are also accepted by telephone, over the Internet or otherwise. Each "traditional auction event" is defined as any day or portion of a day during which a traditional auction sale takes place. So, for example, a library that has an annual fundraising auction at which it sells donated furniture or jewelry will not have to collect sales tax on those sales.

Similar rules will apply if the same library decides to hold a "remote" auction – an auction conducted by remote means (such as online) for a period of time beginning on a common date and closing on a common date, during which one or more taxable items of tangible personal property are offered for sale to the highest bidder. In determining the number of remote auctions the library has held during the year, the state will look to the number of "start" and "end" dates, not the number of items auctioned. If a group of ten items are offered for a period that starts and ends at the same time for all of them, it will count as only one auction.

Sales at Commercial Auction

As of January 1, 2009, if a qualifying exempt organization sells tangible property at a commercial auction house or on any premises where other auction sales are being made, the auction house is required to collect and remit sales tax. This provision will eliminate an advantage that exempt organizations have

had, for example, in selling art. If a buyer knows that he won't have to pay sales tax on a picture, he can afford to spend more on the work itself. That advantage has permitted museums and other exempt organizations to retain a greater portion of the proceeds of the sale of works at auction. The elimination of that advantage may cause exempt organizations to opt more often for private sales of art – introducing a new factor for fiduciaries to consider in determining the means of sale.

****

An exempt organization that makes any taxable sales must register with the New York State Department of Taxation and Finance for sales tax purposes if it has not already done so. Once registered, organizations generally will be required to file quarterly sales tax returns, regardless of whether any sales tax is actually collected.

Despite the expanded application of the New York sales tax, certain exceptions to the duty to collect sales tax still exist, such as:

- Certain types of items are exempt from New York State sales tax, regardless of the method of sale, such as clothing and footwear sold for less than $110 per item of clothing or per pair of shoes, periodicals, and certain drugs and medicines.
- Goods that are delivered outside New York State generally are not subject to New York State sales tax no matter where or how they are sold.
- Sales of goods to purchasers that provide the vendor with a properly completed Exempt Organization Certificate or Resale Certificate are not subject to the New York State sales tax.

This list is not exhaustive and is meant to provide examples of only some of the common exceptions to sales tax applicable to nonprofit charitable, educational and religious organizations. ❖

For more information on this topic, contact Bill Gaske at 212.336.2923 or wfgaske@pbwt.com, Rich Upton at 212.336.2020 or rrupton@pbwt.com, or Jo Laird at 212.336.7614 or jblaird@pbwt.com.

On the Cover

The cover art for this issue is the work of Elliott Arkin. Titled *Le Cadre*, a detail of the work was purchased by the Louvre in 1999 for its permanent collection as a work of art in jewelry. In 2008, Mr. Arkin was awarded the commission to design and create the Above and Beyond Citizen Medal of Honor for the Congressional Medal of Honor Society of the United States. He has also designed a universal human rights symbol to be used by Nelson Mandela's initiative to end the AIDS epidemic and has worked with Muhammad Ali's World Healing Project, designing awards and symbols and developing cultural events. In addition to the Musée des Arts Décoratifs at the Louvre, his work is in the permanent collections of the Whitney Museum of American Art, the National Dance Museum, the New York Historical Society, the New York Public Library, the Flint Institute of the Arts in Flint, Michigan, and the National Dance Museum.

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

We would like to acknowledge the assistance of the following Patterson Belknap associates in the preparation of this issue of *The Legal Canvas*: Megan Bell, Ella Campi, Matthew Larsen, Eric Rasmussen and Carrie Trowbridge.

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:

Hugh J. Freund	**212.336.2370**	**hjfreund@pbwt.com**
John Sare	**212.336.2760**	**jsare@pbwt.com**
Jo Backer Laird	**212.336.7614**	**jblaird@pbwt.com**
Christopher C. Angell	**212.336.2770**	**ccangell@pbwt.com**
Susan F. Bloom	**212.336.2976**	**sfbloom@pbwt.com**
Laura E. Butzel	**212.336.2970**	**lebutzel@pbwt.com**
William F. Gaske	**212.336.2923**	**wfgaske@pbwt.com**
Antonia M. Grumbach	**212.336.2840**	**amgrumbach@pbwt.com**
Kim J. Landsman	**212.336.2980**	**kjlandsman@pbwt.com**
Robert P. LoBue	**212.336.2596**	**rplobue@pbwt.com**
Gloria C. Phares	**212.336.2686**	**gcphares@pbwt.com**
Stephen P. Younger	**212.336.2685**	**spyounger@pbwt.com**

IRS Circular 230 disclosure: Any tax advice contained in this communication (including any attachments or enclosures) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication. (The foregoing disclaimer has been affixed pursuant to U.S. Treasury regulations governing tax practitioners.)

To subscribe to any of our publications, call us at 212.336.2329, email: info@pbwt.com or sign up on our website, www.pbwt.com/resources/publications.