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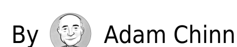
Busting the Guarantees Myths

Getting to Grips With Auction House Practices

By  Adam Chinn

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A great deal has been written about auction house guarantees, and the securing of irrevocable bids to cover those guarantees. Yet much of the coverage is closer to mythology than objective analysis of how the art market operates. This article will try to bust some myths and to provide an overview—not just from my perspective as Sotheby's chief operating officer—but as someone who's seen all sides of the deal: auction house, irrevocable bidder, consignor and regular bidder.

It is clear that guarantees are not disappearing. Of the 166 lots offered by the three major auction houses in their contemporary evening sales in New York last November, 66 were guaranteed (48 of those carried irrevocable bids). Based on the works' low estimates, the amount guaranteed was $300m of a total $535m. Of the $300m, there were irrevocable bids on all but $40m.

Myth #1

The market doesn't like guarantees

This oft-heard refrain deserves some scrutiny. What do we mean by "the market"? If consignors didn't like guarantees, there wouldn't be any. If irrevocable bidders didn't like them, they wouldn't take on the risk. If buyers shied away from guaranteed works, the auction houses would cease to give them. And, if auction houses didn't like guarantees, presumably they wouldn't offer them (as has been the case during previous periods of serious market dislocation, most recently the aftermath of the global economic crisis of 2008).

A guarantee fulfills specific functions, whether coupled with an irrevocable bid by a third party or not. From the consignor's point of view, the work is now guaranteed to sell for a minimum price. The fee charged by the auction houses for this security (typically a percentage of the hammer price above the guaranteed level) is, for some consignors, worth it.

If risk is passed on to a third party willing to place an irrevocable bid, they are happy to own the work. If they're outbid, then the fee they receive for their efforts should assuage their disappointment somewhat.

If there is a separate buyer outside the irrevocable bid deal, there is comfort in the fact that a knowledgeable source has put their own capital behind the lot.

It may be more profitable to arrange a guarantee than provide an enhanced hammer deal

For the auction house, it may be more profitable to arrange a guarantee than provide an enhanced hammer deal to secure the property (where the consignor receives a portion of the buyer's premium in addition to the hammer price). If the house believes in the property's potential for upside above the guarantee, then sharing the hammer above that level provides more profit.

Currently in the market there is an imbalance between supply and demand, with demand exceeding supply. This has increased the auction houses' appetite for guarantees because competition is fiercest for the highest value trophy lots—which have the lowest margins because buyer's premium is reduced to between 12% and 12.5%, depending on the house, above $3m hammer. Enhanced hammer deals are most prevalent at this level, which makes the possibility of retaining the full buyer's premium and earning a share of the upside over the guarantee that much more attractive for the auction houses on a risk/reward analysis.

For what it's worth, the best performing lots in the November 2016 contemporary sales at Sotheby's, compared to low estimate, were those both guaranteed and covered by an irrevocable bid. The market seems fine with guarantees.

By Pablo Helguera

Myth #2

Guarantees can inflate values

I am not sure what this means, although it has taken on the timbre of received wisdom among many art market journalists. This was a fair criticism before the summer of 2016, when the NYC Department of Consumer Affairs made the rules clear: the New York City auction regulations require that any fees payable must be netted from the price, so that what is reported to the public is the net price paid.

As with a non-guaranteed lot, if there are no third-party bidders, a guaranteed work will fail to sell. If there is an irrevocable bidder, it means they have placed a bid, which is a contractual intention to own the work at a certain price.

If the irrevocable bidder is outbid, well, that’s just competitive bidding—which is what happens at auction. This is no more price inflation than any other bidding war on non-guaranteed lots. Rather, the price paid is the going market rate at the time of auction.

An interesting side note is the balance between the private sales market and the public auction market. Usually, public auction houses tend to have stronger results at the top of the market cycle, as we saw in the 2014-15 cycle. In 2016, however, private sales were probably higher than auction prices.

By Pablo Helguera

Myth #3

Some collectors don't even buy at auction any more. No one knows how these deals are being structured. It's like proprietary trading

This is the opacity argument, which holds some merit. A guarantee is a private arrangement between a consignor and the auction house. An irrevocable bid is likewise a private contract. While the existence of the guarantee and bid are disclosed to auction participants, the exact terms are not. While this has nothing to do with proprietary trading (when a party trades on

its own account rather than as an agent), the argument bears examination.

The question is whether the bidder, the irrevocable bidder (assuming they're separate), the consignor and the auction house are all fully informed about their respective economic positions.

For a bidder coming into the auction with no knowledge of the guarantee deal, the price they want to pay for a work is their own decision. That bid is their clear intent to buy.

One might argue that, by securing an irrevocable bid, the auction houses have brought one more bid into the equation that might not otherwise have been there. But this brings us back to the inflation question above: if all the bidders would be happy taking the work home, it's simply fair competition.

The nature of the irrevocable bidder has evolved

As the buyers in the market have become more financially sophisticated, the nature of the irrevocable bidder has evolved. Historically, the fear has been that members of the trade were the primary backers of works at auction to support their inventory. While there is still dealer activity, the pool of backers has significantly expanded, with many new entrants coming from the finance and business worlds.

The logic is simple. I would be happy to own this work for a price of $X and would bid at auction at $X level. Usually, if I am outbid, I go home disappointed. But, if I back the picture, I either go home with the work or I receive a check. The only downside risk is that, perhaps in the absence of my bid, the reserve would have been set lower and I might have been able to buy the work more cheaply.

Auction houses disclose the occasions where they have struck private deals. This is less opaque than the majority of the art market, where buyers have no idea of the mark-up involved. There is an imbalance of information amongst many of its players: not everyone has an art history degree or works in an auction house, museum or gallery.

Ultimately, I believe that all markets tend towards efficiency, transparency and financialization. The ever-evolving nature of guarantees and irrevocable bids are just the most public manifestation of this process. If participants from every side didn't think they were valuable for the smooth functioning of the market, guarantees would disappear.