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## An Analysis of the Court's Decisions Relating to Fair Market Value and the Concept of Blockage in Regards to Artist's Estates

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AN ANALYSIS OF THE COURT'S DECISIONS RELATING  
TO FAIR MARKET VALUE AND THE CONCEPT OF  
BLOCKAGE IN REGARDS TO ARTIST'S ESTATES

Noel Laine Novak-Pilch, B.A.

An Abstract Presented to the Faculty of the Graduate School  
of Lindenwood College in Partial Fulfillment of the  
Requirements for the Degree of  
Master of Science

1996

## ABSTRACT

This thesis will focus on three specific court cases and the relevant decisions as they relate to the hypothetical concept of Fair Market Value and the concept of a blockage discount.

In recent years, cases involving artists' estate holdings of unsold works have dealt with Fair Market Value and a blockage discount. The three main cases are the Estate of David Smith, the Estate of Georgia T. O'Keeffe, and the Estate of Andy Warhol. In all three cases, the court was asked to decide what amount, if any, was to be applied for a blockage discount. While each of these cases is unique in its specific circumstances, there are several common bonds between these three cases.

The court cases are analyzed in regard to the specific market delineation, demand analysis, the court facts, theories, the court decisions and important rulings. Also, the overall implications from the courts' decisions to general appraisal practices are discussed.

Finally, chapter V introduces an alternative valuation solution for the Estate of David Smith. Instead of appraising the estate in the realm of a personal property appraisal,

information will be introduced suggesting that the estate meets most, if not all, of the requirements for that of being appraised as a sale proprietorship of the artist.

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## TABLE OF CONTENTS

List of Illustrations.	v
I. Introduction	1
General Overview	1
Blockage Discount	3
Statement of Purpose	5
II. Literature Review	6
General Overview.	6
Specific Cases	8
III. Selective Review and Evaluation of Research	9
David Smith the Artist Biography	9
Market Delineation and Demand Analysis	11
Court Case Facts	12
Petitioner's Theory	16
Respondent's Theory	16
Court's Decision	17
Important Rulings	18
Georgia O'Keeffe Artist Biography	19

Market Delineation and Demand Analysis . . . . .	21
Court Case Facts . . . . .	23
Petitioner's Theory . . . . .	25
Respondent's Theory . . . . .	25
Court's Decision . . . . .	26
Important Rulings . . . . .	27
Andy Warhol Artist Biography . . . . .	28
Court Case Facts . . . . .	31
Petitioner's Theory . . . . .	33
Respondent's Theory . . . . .	33
Court's Decision . . . . .	34
Important Rulings . . . . .	36
IV. Discussion of the Results . . . . .	37
The Court's Decisions . . . . .	37
Appraisal Implications . . . . .	38
V. Alternative Valuation Approaches . . . . .	40
Future Research . . . . .	42
Illustration 1 . . . . .	46
Illustration 2 . . . . .	47
Illustration 3 . . . . .	48
Appendix A . . . . .	49
Appendix B . . . . .	67



Appendix C . . . . .	76
Addendum 1 . . . . .	80
Works Consulted . . . . .	85
Vita Auctoris . . . . .	88

## List of Illustrations

Illustration 1	David Smith <i>Cubi Series</i>	. 46
Illustration 2	Georgia O'Keeffe <i>Sunset-Long Island</i>	47
Illustration 3	Andy Warhol <i>Marilyn Monroe</i>	. 48

## Chapter I

### INTRODUCTION

#### General Overview

In the United States, the most widely accepted and recognized standard of value is Fair Market Value. In fact, this is a result of the fact that Fair Market Value is the only value estimate accepted by the Internal Revenue Service for such assessments as Estate Tax, Gift Tax or Income Tax Liability including Deduction for Charitable Donations.

Fair Market Value is a hypothetical concept. It is defined as: the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treasury Regulation Sec. 20.2031-1[b]).

It is important to keep in mind that this is a hypothetical sale. According to Shannon Pratt's book Valuing Small Businesses and Professional Practices, "There is general agreement that the definition implies that the parties have the ability as well as the willingness to buy or to sell" (25).

There are several key points or sub-concepts that an appraiser must understand in order to accurately estimate the Fair Market Value of a property. Specifically, Fair Market Value of a particular property included in a decedent's gross estate is not to be determined by a forced sale price or determined in a market other than that in which the property is most commonly sold to the public. The appraiser is responsible to determine the most active, relevant and appropriate market in which to appraise each property. The determination of the appropriate market is of central importance to understanding and appropriately estimating the Fair Market Value of the property where it is most commonly sold to the public. Of course, the appraiser must take into account the location of the property when appropriate.

With this in mind, it is important to stipulate that if a property included in a decedent's gross estate is normally obtained by the public in the retail market, the Fair Market Value of such a property is the price at which the property or comparable property would be sold at retail.

The definition of Fair Market Value must be understood when an appraiser is estimating this value for the intended

use of federal estate tax. In the past twenty years there have been several cases that have come before the United States courts in which the concept of Fair Market Value and the concept of blockage were discussed and analyzed.

### Blockage Discount

Blockage is a concept that deals with timing. Basically, blockage is a form of depreciation resulting from a number of similar properties being offered that is too large for the normal market to absorb as of a specific date. A blockage discount, is an adjustment to the value of a particular property accounting for the over loading of the market due to the large number of similar properties being offered simultaneously.

The term comes from the first cases where discounts were applied to the value of large blocks of stock. In this way, the court analyzed an Absorption Rate, i.e., the rate in which the appropriate market could absorb the stocks, and an adjustment was subsequently made.

Blockage takes into account the principle of supply and demand. If there is a greater supply than the demand, then



the value or price of the property may depreciate. But, if the demand is greater than the supply, then the property might cost more to purchase. This is because people who want particular types of properties have less of them to choose from, making them in greater demand.

In recent years, cases involving artists' estate holdings of unsold works have also allowed similar blockage discounts. The three main cases are the Estate of David Smith, the Estate of Georgia T. O'Keeffe, and the Estate of Andy Warhol. In all three of these cases, the court was asked to decide what amount, if any, was to be applied for a blockage discount. While each of these cases is unique in its specific circumstances, there are several common bonds between these three cases.

All three of these cases deal with the works of prolific, recognized artists, who at the time of their deaths owned substantial numbers of their own works. Again, in all three cases, appraisers applied different amounts of a blockage discount to the individual Fair Market Value of the works. And in all three cases there were varying amounts of documented statistical data to substantiate the anticipated blockage discount.

The decision of the court in each of these cases, is not

much better. In fact, in two out of the three cases, it appears that the court just split the difference between the petitioner and the respondent. In some cases the court was no better than the appraisers in providing analytical information for the decisions made.

Chapter II will review the important and pertinent literature that was utilized in creating this thesis. The literature ranges from those of general appraisal information, i.e., defining and explaining Fair Market Value and Blockage Discount, appraisal approaches, etc., also, literature dealing with these three major court cases.

Chapter III will focus on the Estate of David Smith, the Estate of Georgia T. O'Keeffe and the Estate of Andy Warhol in regards to the specific market delineations and demand analysis for each case, the court facts, the theories, the court decisions and the important rulings. After the cases have been analyzed and the decision of the courts understood, the overall implications will be discussed in chapter IV. In conclusion, chapter V will introduce an alternative valuation solution for the Estate of David Smith and some suggestions for further future research in this area.

## Chapter II

### LITERARY REVIEW

#### General Overview

The literature utilized for the research of this topic can be broken into three classification: general to specific appraisal literature, articles dealing with the Estate of Andy Warhol, and the court case literature.

#### Appraisal Theories

There are numerous books that have been written dealing with the theories and methodology of appraising. All of the sources that are available are rooted in the same basic principles. This is due to the fact that Personal Property, Machinery and Equipment, and Business Valuation all came out of Real Estate appraisal.

Henry Babcock's book Appraisal Principles and Procedures was written in 1980 and deals with the concepts



and procedures in appraising real estate. This book is one of the founding blocks of the concept of Fair Market Value.

Shannon Pratt is one of the most well recognized Business Valuation appraisers in the country. He is well known throughout the American Society of Appraisers and has written numerous books on the appraisal of businesses and their assets. Specifically, the following books were found useful in explaining business valuation concepts and procedures; Guide to Business Valuations, Valuing Small Businesses and Professional Practices, and Valuing a Business; The Analysis and Appraisal of Closely Held Companies.

Finally, the Personal Property handbooks are filled with pertinent information dealing with the concepts of Fair Market Value and of a Blockage Discount.

### Articles

From 1988 until the end of 1994 numerous articles were written dealing with the Estate of Andy Warhol and specifically trying to answer the question of his worth. Paul Alexander has written several articles from 1992 to 1994 dealing with these very questions. His articles, "How Much Is

Andy Worth," "Putting A Price on Andy," and "What Happened to Andy's Treasures," all try to examine the controversy over the worth of Andy Warhol's estate.

### Court Cases

The most helpful and utilized literature is that directly given in the court cases themselves. This literature contains specific information on topics such as the amount of properties in the possession of the estate at the time of death, the blockage discount that the appraisers argued, and the court's decisions. This information is not only useful, but also necessary for appraisers to understand the theories and rationale behind the court's rulings that affect the concepts of Fair Market Value and of a Blockage Discount.

### Chapter III

#### SELECTIVE REVIEW AND EVALUATION OF RESEARCH

##### David Smith the Artist Biography

David Smith (1906-1965) is regarded by most art historians and basic art history texts as "the foremost American sculptor of the Post-World War II period" (The Random House Dictionary of Art and Artists, 490). His career began in the 1920s when he began studying painting and became most familiar with European Cubism. Cubism is defined as "a movement in 20th-century painting and sculpture that by rejecting the naturalistic tradition revolutionized painting and sculpture. The aim of Cubism was not complete abstraction, rather a new kind of realism" (Hartt, 896).

In the late 1920s, he was employed as a metal worker in the car industry. He was very familiar with iron and steel. Around 1930, he first saw illustrations of Picasso's welded metal sculpture. With his already attained knowledge of different metal materials and the inspiration of Picasso's sculpture, Smith began working with metal sculptures as an art form.

His first welding sculptures incorporated objects and

machinery parts, a practice that he was to continue regularly through his career. His sculptures while being non-representational evoked a suggestion of figures, landscapes or still-lives. The form that the sculpture took was of importance to the artist, but of just as great of importance was the texture of the surface, i.e., polished, burnished, painted or left rough. Most of his works have an open, skeletal structure.

Starting in the late 1950s until his death in 1965, his work began to be more "opaque or volumetric" (The Random House Dictionary of Art and Artist, 490). He also worked in large series, with his most well known series being his *Cubi Series* (Illustration 1). The *Cubi Series* are mostly made up of vertical constructions build-up from boxes and cylinders of polished stainless steel.

It is important to explain that these sculptures that David Smith created are not small, decorative sculptures which would be placed on a coffee table in a home, but instead are large sculptures ranging from 8-10 feet in height and 6-10 feet in width.

### Market Delineation and Demand Analysis

Starting in 1938, David Smith began showing in One-



Man Exhibition. Throughout his artistic life, he was in a total of 49 One-Man Exhibitions. Smith created his sculptures at Bolton Landing, New York. From 1940 to 1956, Smith was represented by the Willard Gallery, New York, and a total of 53 sculptures were sold for a total price of \$33,432.50. These 53 sculptures ranged in price from \$40.00 to \$3,213.00.

In 1957, Smith changed galleries and from 1957 to 1963 was represented by the Otto Gerson Gallery, New York and sold a total of 17 sculptures for a total price of \$76,148.00.

Again in 1963 he changed representation to the Marlborough Gallery who from 1963 to 1965 sold 5 sculptures for a total price of \$72,335.00. For the most part, these sculptures were purchased by major corporations, trust companies, cities and public areas due in some part to their immense sizes.

In 25 years he sold 75 sculptures through three galleries. During this period of 25 years he created a total of 500 sculptures, leaving 425 sculptures unsold at his death in 1965.

Court Case Facts (Appendix A)

On May 23, 1965 David Smith died from injuries sustained in an automobile accident. At the time of his death, Robert Motherwell, Clement Greenberg, and Ira M. Lowe qualified as co-executors of the decedent's estate. A federal estate tax return was filed on August 24, 1966, with the district director of the Internal Revenue Service in Albany, New York.

In order to understand the executor's strategy and the final out-come on the federal tax return, it is imperative that first one understands and is privy to the following information. On or about June 2, 1963, Smith and Marlborough Galleries entered into an agreement detailing both parties responsibilities in the selling of his work. The following excerpts are taken from Est. of David Smith, Cite as 57.67 P-H TC, which stated as follows:

1. During such period of 5 years, we shall also have exclusive right to arrange and to authorize others to arrange the publication and/or sale, in any part of the world, of books and catalogues containing illustrated reproductions of your work.

2. During such period of 5 years, we shall arrange for exhibitions of your work in New York, London, Rome and such other places as you and we shall jointly determine. We shall be responsible for all of the expenses of such exhibitions (including advertising and catalogue costs) other than insurance and shall bear the entire cost of storing all items of your work delivered to us pursuant to this agreement.

3. You have furnished us with photographs of each item of your work owned by you on the date hereof. The price at which we shall offer each such item for sale shall not be less than the price set forth on the back of such photograph. We shall agree with you as to the minimum sale prices of those items of your work created in the future. Minimum prices may be changed from time to time in such a manner as you and we shall jointly agree.

4. Upon the sale by us of any item of your work, we shall reimburse ourselves from the actual net proceeds for any initial shipping cost and insurance cost advanced to you with respect to such item. In addition, as compensation for our services, we shall retain 1/3rd of the balance of such net proceeds. The remaining 2/3rds of such balance, less any amount due to us hereunders, shall be paid to you in United States dollars on a quarterly basis.



5. This agreement shall be construed in accordance with the laws of the State of New York and shall be binding upon and inure to the benefit of your and our respective executors, administrators, successors and assigns.

The above agreement between David Smith and Marlborough Gallery was in effect from 1963 to 1965, during which time the following sales information and break down of funds took place.

<u>Date</u>	<u>Total</u>		
<u>Work Sold</u>	<u>Sales Price</u>	<u>Commissions</u>	<u>Artist</u>
Nov. 20, 1963	\$6,000	\$2,000	\$4,000
June 29, 1964	\$14,000	\$4,666	\$9,334
Nov. 12, 1964	\$40,000	\$13,333	\$26,667
Nov. 14, 1964	\$8,500	\$2,833	\$5,667
Jan. 17, 1965	\$40,000	\$13,333	\$26,667

In valuing the works of art included in the federal tax return, the executors first computed the price that each piece would bring if sold individually at retail on the date of death. A total hypothetical price was estimated of \$4,384,000.00. But this is not the amount that they entered on the federal tax return. The executors then discounted this figure by 75 percent on the theory that these works could only be sold at the time of death to a bulk purchaser for resale. The figure was then reduced by 1/3rd to cover the agreement amount



that would be paid in commission to Marlborough Gallery. The resulting figure of \$714,000.00 was reported on the federal tax return as the value of the sculptures as of the date of death of David Smith.

Estimated Value	<u>Minus 75%</u>	=	Amount Before Commission
\$4,284,000.00	- \$3,213,000.00	=	\$1,071,000.00

Amount Before Commission Return	<u>Minus 1/3rd</u>	=	Estimated Value on Federal Tax
\$1,071,000.00	- \$357,000.00	=	\$714,000.00

This 75 percent discount for the selling of the sculptures to a purchaser for resale would be known as a blockage discount taking into account the absorption rate of the appropriate market to the amount of works. The Internal Revenue Service originally estimated \$5,256,918.00 for the value of the 425 sculptures unsold at the time of death. The IRS later agreed with the estimated value of the estate of \$4,284,000.00 if the sculptures were sold on a piece by piece basis. The IRS did not however agree with any amount of discounting for blockage or with the 1/3rd commission to Marlborough Gallery.

### Petitioner's Theory

The estate took into account the cost of selling (brokerage commissions) the works when estimating the Fair Market Value entered on the federal tax return. They believed that there was sound logic used in estimating the value as explained previously. The discount or blockage discount was given due to the fact that the market could not in their eyes absorb such a large block of works by this one artist. It is important to keep in mind that most of these works were very similar and large in size. Had the large number of artistic works which David Smith left at his death been generally known and had all of these works been immediately placed on the market, they would have brought substantially less than could be received by feeding them slowly into the market over a period of time.

### Respondent's Theory

The Internal Revenue Service argued that the petitioner's value does not reflect the retail market, as mandated by the Estate Tax Regulations (Sec. 2031-1[b]). The Internal Revenue Service went on to state that such

simultaneous availability would have no adverse impact and that the Fair Market Value of each item should simply be determined by the price at which the item could be separately sold in the retail art market on a 'one-at-a-time' basis.

#### Court's Decision

The court found that the discount rate or blockage discount of 75 percent was too high. The court did not offer any reason or supported information in their findings. But the court did take into account that each willing buyer, which is a stipulation in the definition of Fair Market Value, would realize that 424 other comparable items were currently offered for sale when determining the price they would be willing to pay for any item.

The court goes on to explain that "under the foregoing circumstances, we think that, in this, case, the amount which an *en bloc* (blockage discount) purchaser for resale would pay and the aggregate of the separate 'one-at-a-time' value to be obtained by a variety of dispositions in the 'retail market' would be that same" (57 TC 650, 658).

When left with the question about the 1/3rd commission discount, the court cited *Publicker v. Commissioner* (206 F.2d

250 [1953]) and Estate of Frank Miller Gould v. Commissioner (14 TC 414 [1950]). The court found that the selling costs to be clearly precluded by judicial precedent. "In the aforementioned cases, the court observed the measure of value as laid down by these cases to be what could be received on, not what is retained from, a hypothetical sale" (The Appraisal of Personal Property, 195).

The court found that the Fair Market Value of the 425 sculptures unsold at the time of Smith's death to be estimated at \$2,700,000.00.

### Important Rulings

It is important to keep in mind that this is not the first court case to deal with the concept of a blockage discount, but is the first court case to involve this concept with that of an artist's estate. With this in mind, it is understandable that the tax court is empowered with the freedom to "find it unnecessary in this unusual case, to make any hard and fast choice between the two approaches urged by the parties" (57 TC 650, 657).

The next significant case to come through the court system dealing with the concept of a blockage discount was the Estate of Georgia O'Keeffe.



### Georgia O'Keeffe Artist Biography

Georgia O'Keeffe was born in Wisconsin on November 15, 1887, to a typical farm life. She had a strong family life with many brothers and sisters. By the age of 17 Georgia had enrolled in the Art Institute in Chicago, Illinois.

Her family began to undergo some financial strains after moving to Charlottesville, North Carolina. In order to help ease the financial strain, George ventured out to become a painter. She found that there were very few female predecessors, and there was no tradition of women as artists.

From 1912 to 1918 she worked at intervals in Texas, where she was deeply impressed by the landscape. In 1915, she began to work in a series of drawings and watercolors that were abstract in nature and suggested strong natural forms in a sparse open style. By the age of 30, Alfred Stieglitz entered her life. He was a master of photography, but was 60 years old and married. He demanded constant loyalty from Georgia (Hartt, 928). During the next 10 years she developed her style which was a focus on flowers and New Mexico landscapes.

By 1935, she was acquiring stature in her field as a serious artist. She then was offered and took on commercial projects. She was honored by being chosen as one of the 12

most outstanding women of the previous 50 years in the arts. Her painting *Sunset-Long Island* was chosen to represent New York State at the World's Fair (Illustration 2). By the 1940s her reputation continued to grow. She produced some of her greatest landscapes and she was at her peak. After Alfred Stieglitz death in 1946, she began the formal, stately *In the Patio* series. She also selected certain dealers to sell her works on her behalf. "Whether she sold through an agent or directly, O'Keeffe imposed strict conditions and guidelines regarding the hanging and framing of her works, how often they were to be lent and to whom, and their subsequent dispositions" (Estate of Georgia t. O'Keeffe Cite as 1992 RIA TC 1052-92).

In 1973 a young unknown artist, Juan Hamilton, entered her life. At first, he did odd jobs around her house, but by 1978 he was given power of attorney and in 1979 was named executor of her will. During this period, Georgia was still painting and gaining more and more recognition in the art world. In 1986, Georgia O'Keeffe died at the age of 98 leaving everything to Juan Hamilton (The Random House Dictionary of Art and Artists, 382).

### Market Delineation and Demand Analysis

Throughout her life, Georgia O'Keeffe created between 1,100 and 1,200 works of art. From 1920 to 1946 her works were distributed by the Alfred Stieglitz Gallery in New York. From the mid 1970s until her death in 1986, her works were distributed by Juan Hamilton. O'Keeffe's works were not just of commercial success, but also of artistic merit. There was a major exhibition of her works held at the Whitney Museum of American Art in New York in 1970. This exhibition then traveled to Chicago, Illinois, and finally San Francisco, California. Sales results from auction records show a steady increase in value and monies received from the 1970s and early 1980s. In 1979, for example, the average price of a work sold by O'Keeffe jumped from tens of thousands of dollars to \$121,000.00 and by 1983, the average price of a painting sold by Georgia O'Keeffe personally rose to a high of \$631,250.00 (Estate of Georgia T. O'Keeffe Cite RIA TC 1052-92).

The following is a list by year from 1979 to 1991 of the

prices realized from Sotheby's and Christie's of New York for works by Georgia O'Keeffe.

<u>Year</u>	<u>Prices Realized</u>
1979	\$196,500.00
1980	\$1,100,000.00
1981	\$152,500.00
1982	\$400,000.00
1983	\$420,000.00
1984	\$1,005,000.00
1985	\$1,200,000.00
1986	\$410,000.00
1987	\$8,260,000.00
1988	\$715,000.00
1989	\$4,405,000.00
1990	\$2,905,000.00
1991	\$575,000.00

The above figures are just those sales from two major auction houses and do not include any sales from retail galleries. It is much more difficult to obtain and verify sales through galleries, but accounting to Estate of Georgia T. O'Keeffe Cite RIA TC 1052-92, "From 1979 through 1986, one gallery sold 16 of O'Keeffe's works on canvas, 24 works on paper, 1 work on wood panel and 4 sculptures." These works ranged in prices from \$60,000.00 to \$1,000,000.00 for works



on canvas, and \$6,000.00 to \$120,000.00 for works on paper. At her death she was in possession of 400 works. These works ranged in quality from a few top quality pieces, smaller and lesser works of medium quality, and studio leftovers to unfinished works.

#### Court Case Facts (Appendix B)

The estate of Georgia O'Keeffe employed Eugene Victor Thaw to appraise the O'Keeffe works in the estate for the federal tax return. In valuing the works of art included in the federal tax return, Mr. Thaw first computed the price that each piece would bring if sold individually at retail on the date of death. A total hypothetical price was estimated at \$72,000,000.00. But this is not the amount that they entered on the federal tax return. The appraiser, Mr. Thaw, then discounted this figure by 75 percent on the theory that these works could only be sold at the time of death to a bulk purchaser for resale. The resulting figure of \$18,000,000.00 was reported on the federal tax return as the value of the works of art as of the date of death of Georgia O'Keeffe.

<u>Estimated Value</u>	<u>Minus 75%</u>	=	<u>Estimated Value on Federal Tax Return</u>
\$72,000,000.00	- \$52,000,000.00	=	\$18,000,000.00

The Art Advisory Panel (AAP) of the Internal Revenue Service proposed the following changes: (a) an adjustment to a portion of the individual artwork appraised valued; a determination that the bequeathed art should be excluded from the application of a blockage discount; (b) a segmented approach in the application of the blockage discount based upon appraised values; and (c) the application of differing blockage discounts to each segment.

The estate, along with Mr. Thaw and the Art Advisory Panel were able to agree on the previously mentioned changes. What the court was asked to do was to determine the appropriate blockage discount to apply to the works.

#### Petitioner's Theory

The petitioners had a total of three prominent experts presenting information to the court. Mr. Thaw, was not only the appraiser hired by the estate, but was also an art dealer,

collector, consultant and expert witness in the David Smith case and was a former member of the Art Advisory Panel. The second expert for the petitioner was Mr. James Maroney an art dealer specializing in early American modernist art and also a former member of the Art Advisory Panel. The third expert that the petitioner called on was Mr. Anthony M. Lamport an investment advisor and advisor to venture investors. These three experts tried to stress to the court that in 1986 the art market was at or near its peak. They explained that the factors that establish value in the art market are: rarity, quality, size, subject matter, medium and condition. These experts believed that the estate's O'Keeffe art works constituted at least a 10 year supply of works, because one needs to keep in mind the absorption rate that the market can handle at any given time.

#### Respondent's Theory

The respondents had two experts that would address the court. The first expert was Mr. Warren Adelson a dealer of American Art and a member of the Art Advisory Panel and Mr. Larry Walther, Ph.D., an associate professor of financial accounting topics. The experts testified as to the art market



in general as of the date of death and specifically in regard to the decedent's art work in the relevant market. These experts reiterated the Art Advisory Panels previous suggestions, such as the art work should be categorized as "Bequested Art" and "Remaining Art" with zero blockage discount assigned to the "Bequested Art." They also asked that the "Remaining Art" should be categorized by price with only a 10 percent discount assigned to works with a value over \$2000,000.00. These experts believed that these pieces of art work could be sold in a few years and would not require a higher blockage discount. For "Remaining Art" with a value of less than \$200,000.00 should have a 37 percent blockage discount since it would take a longer amount of time to sell these pieces (The Appraisal of Personal Property, 112).

#### Court's Decision

The court rendered an opinion that a blockage discount of 25 percent should be applied to half the works; and 75 percent to the remainder of the works. This resulted in an evaluation of \$36,400,000.00 or a 50 percent discount rate for blockage. This court case has been nicknamed the 'split-the-difference' case since that is what the court has apparently done.

The court stated that "although each of the experts was qualified to express an opinion on the subject matter on which they were called to testify, each of them suffered from the same tendency to ignore relevant facts inconsistent with the position of the party employing the expert and to exaggerate facts consistent with the view espoused" (Estate of Georgia T. O'Keeffe Cite RIA TC 92-1055).

#### Important Rulings

It is important to understand as appraisers that the court felt that if there is significant variation in the art work according to the identified factors that are establishing value, such as rarity, medium, size, etc., then the art work should be segmented to take such variations into account. These various segments should then be addressed individually by the appraiser in the Market Analysis section of the appraisal. The experts in the O'Keeffe case may have done this type of segmentation and market analysis in their head, but the court was not given this type of informative information. This left the court troubled by the lack of objective analysis collaborating their testimony.

The next significant case to come through the court system dealing with the concept of a blockage discount was the Estate of Andy Warhol.

### Andy Warhol Artist Biography

Andy Warhol (1928-1987) was an American painter, graphic designer and film-maker. Andy Warhol is practically a household word. He is probably one of the greatest known Pop artists. Pop art is an artistic movement arising in the mid 1950s in Britain and the United States. The height of the movement was in the early 1960s. The term 'Pop art' was coined by the critic Lawrence Alloway to describe ironic works celebrating the imagery and techniques of the mass media, advertising and popular culture (The Random House Dictionary of Art and Artist, 418).

In the 1950s Warhol was working as an advertising illustrator and did not make his debut as a painter until 1962. At his debut, Warhol exhibited stenciled pictures of multiple dollar bills, Campbell's soup cans and Coca-Cola bottles. He specialized in depicting the boring and ordinary images. Warhol created variations of popular American cultural icons in a mass media format (Hartt, 940).



During the 1960s, Warhol worked towards a goal of machine-like art devoid of emotional and social comment in a New York studio called 'The Factory'. One of his most famous images is that of *Marilyn Monroe* (Illustration 3) created in 1962 as a silk-screen print in garish colors.

In 1966 Warhol announced his retirement as an artist in order to devote himself to producing films. And from that point forward, Warhol still created art, worked on films and was a name in the right circle.

Warhol checked into a New York Hospital on Friday, February 21, 1987 in order to prepare for a three hour operation to remove his gallbladder, which was gangrenous, on the following day. Sometime between 9:30 P.M. and 5:45 A.M., after the surgery, Warhol appeared to have suffered a fatal heart attack ("What Happened to Andy's Treasures?", 28).

There are three key players in the controversy and eventual court case involving the estate of Andy Warhol. The first player is Fred Hughes, executor to the Warhol estate. Fred Hughes was the long time Warhol confidant and businessman. Hughes is one of the three key players in the controversy and eventual court case dealing with Andy Warhol's estate. In Bob Colacello's book Holy Terror: Andy Warhol Close Up, Colacello writes of Fred Hughes, "In a few

years, Fred engineered the rise of Andy Warhol from the demimonde to the Beau monde, and set him on the road to real riches. He launched the commissioned-portraits goldmine, drove up the sales and prices of the Sixties paintings, expanded the limited edition print business, cultivated important new collectors and dealers, especially in Europe" (125). Hughes received \$250,000.00 from the will and was then entitled to a 2 percent commission fee.

The second key player is Eddie Hayes, an attorney hired by Fred Hughes, as the executor's lawyer. Hayes is a Columbia University School of Law, class of 1972 graduate. And this is where some of the controversy started. Within a day of Warhol's death, Fred Hughes hired Eddie Hayes and Hayes had a contract drawn up and Fred had signed it. The document read, in part, according to Christopher Byron's article, "Andy's Magic Money Machine"

This letter will serve as a retainer agreement between you as the Executor of the Estate of Andy Warhol and I as your attorney. As attorney for the estate, I shall probate the will, assist you in collecting the assets of the estate, review all claims against the estate, negotiate those claims against on your behalf as executor, establish a foundation as required by the will, transfer assets to the legalese named in the will, prepare all estate tax returns and all fiduciary income tax returns, attend to the proper accounting of all estate transactions and, in general, assist you in all the normal



activities of estate administrator. In return for these services, I shall be paid an attorney's fees amounting to 2.5 percent of the gross taxable estate.

At this point in time no one has any idea as to the extent of the estate. As time starts to pass, Hughes apparently realized by April, 1987, that the estate was so large that paying Hayes 2.5 percent was simply going to be too much. They redrafted the agreement giving Hayes only 2 percent of the gross taxable estate.

The third key player in this case is Archibald L. Gillies. Gillies was former head of the John Hay Whitney Foundation and more recently in charge of the World Policy Institute. By the summer of 1988, Gillies was working as a paid outside consultant for the newly established Andy Warhol Foundation for the Visual Arts. It was not long until, at the beginning of 1990, when Gillies became president of the foundation. Soon after his presidency, Gillies was granted a seat on the board of directors of the foundation (Byron, 89-102).

#### Court Case Facts (Appendix C)

The problem started with Hughes, Hayes and Gillies. All the participants acknowledged that Warhol's non-art assets—his real estate, stocks, bonds, films, and the \$25.3 million worth of collectibles Sotheby's sold in 1988 totaled

\$119,000,000.00. What no one could agree upon was what Warhol's own art was worth.

In Warhol's possession as of the death date was a substantial amount of his art work. He had 4,118 paintings, 5,103 drawings, 19,086 prints and 66,512 photographs.

Hughes hired Christie's in early 1990 to estimate the Fair Market Value on these works. Christie's looked at each work and then came to a total. Christie's final figure, the Fair Market Value estimate was \$95,000,000.00.

Hayes was completely shocked. Hayes was getting paid 2 percent of the value. As a result, Hayes hired Jeffrey Hoffeld, a Manhattan art dealer who does appraising work for the Internal Revenue Service and others to conduct another appraisal. Hoffeld looked at each work and then came to a total of \$708,000,000.00.

With the difference between the two sides so large, talks finally broke down. Hayes filed suit against the estate in Surrogate Court to get what he claimed was his \$8,000,000.00. At that time, the New York State attorney general's office accused Hayes of "fraud and overreaching for seeking to enforce an unconscionable and unfair retainer agreement" (Byron, 103).

### Petitioner's Theory

Hayes and Hoffeld did not believe that a blockage discount should be needed because the Warhol works are going to appreciate in value over the years. According to Hayes, "the concept [blockage discount] really had no reliance; by the time the last painting reached the market, in five or ten years, it could be worth more than the gross national product of Latvia" (Byron, 101). Both Hayes and Hoffeld believed that no absorption rate needed to be analyzed in estimating value.

The petitioner's appraisers also used retail values in many cases and did not consider or blend in auction sales. The valuation was at the very high end of the spectrum.

### Respondent's Theory

The foundation (estate) retained Christie's Appraisal Inc., to perform the appraisal on the Warhol art works. Christie's and Hoffeld agreed that each medium should be subdivided into categories such as 1960s, self portrait Polaroid, etc. Christie's looked at each work and then came to a total of \$265,000,000.00. But, since there was such a great number



of works, Christie's applied a blockage discount ranging from 60 to 90 percent. After the blockage discount was applied, Christie's found that the total Fair Market Value of the Warhol works to be valued at \$95,000,000.00.

### Court's Decision

The court found that the petitioner's appraisers used comparables from the high end retail galleries without considering auction results. The court also found that a blockage discount was not only appropriate, but also necessary.

The court found that Christie's failed to look at markets other than that of Christie's and Sotheby's. They failed to consider even its own sales if they were in conflict with their opinion of value. Christie's appeared not to study or analyze the general market or the Warhol specific market.

Specifically, Christie's blockage discounts to each category were not substantiated with comparables. For example, the Polaroid valued at \$75-2,000.00 with a 90 percent blockage discount left them valued at \$7.50-200.00 when recent sales of Warhol's Polaroid realized prices of \$4,500-7,500.00. The paintings had comparable sales information of actual sales that were 50 to 100 percent higher than the Christie's appraisal. Then Christie's added an

additional blockage discount of 20 percent. There were comparable sales that showed that the drawers were selling in some cases for as much as 7 times the Christie's appraised value. And finally, the prints were valued by the same appraiser at 20 to 150 percent higher when doing an appraisal for insurance purposes. Also sales by Christie's were 40 percent higher than the appraised value.

While Preminger was critical of Christie's in general, she singled out Martha Baer, the senior director of twentieth-century fine arts who oversaw the auction houses appraisal. Preminger believed that Baer ignored "innumerable sales consummated by other auction houses and dealers ("Putting a Price on Andy, 26)." Baer was not able to explain the reasoning behind the blockage discount that Christie's applied to the works.

On April 14, 1994 Surrogate's Court judge Eve Preminger decided that "Warhol's art was worth \$391,000,000.00, four times more than the value Christie's placed on it" ("Putting a Price on Andy", 26). Preminger arrived at this number by pricing each of the four categories of Warhol's art: "The paintings, sculptures, and collaborations had a net worth of \$249,000,000.00 (Preminger reduced their unit value of \$312,000,000.00 by 20 percent blockage discount); the drawings, \$29,500,000.00 (\$45,500,000.00



reduced by 35 percent); the prints, \$48,000,000.00 (\$68,600,000.00 reduced by 30 percent); and the photographs, \$64,000,000.00 (\$80,000,000.00 reduced by 20 percent)" (Estate of Andy Warhol). Once the judge added the \$119,000,000.00 worth of other assets, i.e., real estate, stock, bonds, etc., the fixed value of Warhol's entire estate was valued at \$510,000,000.00.

With this judgment, Hayes could be owed as his legal fee \$10,200,000.00. Also, this changes the amount of monies that the foundation gives to the public. Under New York State Law, the Warhol foundation is required to give away 5 percent of the value of its assets each year to the public.

### Important Rulings

It is extremely important that the appraisers consider the nature and number of art works that are being appraised. The marketability of the particular artist must also be considered and explored by the appraiser.

## Chapter IV DISCUSSION OF THE RESULTS

### The Court's Decisions

All three of these court cases have helped to further the understanding and knowledge of the concept of a blockage discount and in some ways what the courts may be looking for. Blockage is essentially a form of depreciation resulting from a large number of similar properties being offered that is too large for the normal market to absorb as of a specific date.

In the Estate of David Smith, the court agrees with the argument made by the executor (petitioner) that the "impact of ... simultaneous availability of an extremely large number of items of the same general category is a significant circumstance which should be taken into account" (The Appraisal of Personal Property, 109). But, the court did not agree with the amount of blockage discounting that the petitioners believed was necessary. And the court felt that the paying of the commission to the Marlborough Gallery was not necessary under the law and that the 1/3rd commission could not be taken off. Basically, the court gave a 'split-the-difference' decision between the valuation of the executor and

the Internal Revenue Service.

In the Estate of Georgia T. O'Keeffe, the court felt that there were inadequacies when the appraisers applied a blockage discount. The blockage discount seemed to have been arbitrarily applied without any rationale of evidence for its use. Also, the court believed there was a confusion between blockage and averaging. Averaging a large number of similar properties must be shown to have a reasonable basis for such assumptions, and averaging is not blockage.

In the Estate of Andy Warhol, the court felt that these factors must be considered: (a) nature and number of the art works; (b) the marketability of the particular artist; (c) the likelihood of future markets for the work; (d) the stability or permanence of the reputation of the artist; (e) the likelihood of appreciation; (f) the risk of depreciation, which is the risk factor; (g) the length of time necessary for the various markets to absorb all of the work.

### Appraisal Implications

In any attempt to estimate a blockage discount the appraiser must fully research and analyze each component of the artist, market, and economy.



First, a general analysis of the overall markets and trends must be recognized and addressed. Then a thorough analysis of the past performance of the market to a specific artist is essential.

Each artist has a very unique and specific performance record that can be traced and analyzed. The appraiser is not only looking for trends in the market, but also for the absorption rate in which properties are absorbed and excepted into the market without any adverse effects.

The theory of supply and demand is at work. In order to maintain a steady market level, the supply cannot be greater than the demand. If the demand is greater than the supply, then the market will devalue the property.

Also, if the work of an artist is in more than one medium, then the appraiser needs to divide the works according to categories and analyze each of the appropriate markets individually.

The concept of blockage is essentially one of timing. A discount may be allowed due to the large quantity of any one thing. The amount of the discount would be determined in part on reasonable estimates of the time it would take to sell the entire quantity in smaller lots. The opportunity cost of holding the inventory, the carrying cost of the inventory, and extent of the collection all must be addressed and analyzed.



Chapter V  
ALTERNATIVE VALUATION APPROACHES

Was the approach taken by the appraiser in the David Smith estate the only approach to take? According to Terry Melia, CPA, the answer is no. Mr. Melia is a tax partner for Arthur Anderson & Co., currently head of the tax division in the Albuquerque office. He has served as income and estate tax advisor to various artists, including Georgia O'Keeffe. Mr. Melia contends that not all artist estates would benefit from an appraisal focusing on the artist's respective proprietorship interest instead. Mr. Melia suggests that each appraiser should consider whether to value the estate as works by an artist or as an proprietorship interest.

There are many criteria in order to value the estate as a proprietorship interest. In the Estate of David Smith, it appears that his estate would meet the requirements for a proprietorship existing. First of all, the appraiser needs to look at the amount of artistic creativity in the period preceding the artist's death. Smith was continuing to produce and market his sculptures. Secondly, the Marlborough Gallery consignment agreement that authorized the gallery and others to offer for sale all items of his work for which he was the

owner. Just two years before his death, Smith entered into this agreement. Thirdly, the consignment agreement required that the delivery of sculpture be delivered to the location that the gallery indicated. So the gallery had the choice of locations for marketing, and selling of the sculptures. And finally, the fact that the consignment agreement was binding upon and inure to the benefit of David Smith and the galleries respective executors, administrators, successors and assigns. This seems to be a means of planning for the agreement to continue even after the death of the artist.

By looking at the estate and the artist's works as a proprietorship instead of just works in an estate, some of the costs that the court did not allow to be deducted may have been allowed. While the court ruled against deducting the consignment commissions as a reduction of the individual Fair Market Value of each sculpture, under Rev. Rul. 59-60 (Addendum I), asset valuation, consideration should be given to the enterprises operating costs. This way, the costs such as consignment commissions, storage, etc. would be allowed. Giving consideration to selling expenses in determining the individual asset value when utilizing the net asset value approach to value of an enterprise.

The asset value approach or asset accumulation method of valuation is a common asset-based business valuation

method. The theory behind this approach is simple: the value of the business is the value of the business assets (tangible and intangible) less the value of the business liabilities (recorded and contingent) (Valuing Small Businesses and Professional Practices, 239-259). In other words, the appraiser would estimate the Fair Market Value for each of the individual properties, in this case sculptures, then the appraiser would minus the costs projected with the marketing, storage, and sale of the sculpture. The appraiser would also take into account the amount of sculptures being offered into the market at a specific point in time and discount accordingly, otherwise known as a blockage discount.

If an appraiser were to analyze Estate Tax Regulations 20.2031-1 (b) and 20.2031-3, then the art work or sculptures in this case should have been valued as part of a proprietorship since these art works or sculptures would have been offered for sale in the normal course of business.

### Future Research

With a greater understanding of the business valuation theories and concepts for valuing a small business, specifically a sole proprietorship, one could actually attempt to re-appraise the Estate of David Smith in respect to a business



valuation appraisal for the intended use of estimating estate tax.

The first question that needs to be asked and answered is whether or not a proprietorship existed in the David Smith case. This is the first question that needs to be considered in order to determine if a business valuation appraisal of a sole proprietorship would be appropriate. According to Terrence M. Melia's article, Revenue Ruling 59-60 An Alternative to Blockage in the Valuation of Artists' Estates, the following facts indicate that a proprietorship existed in the David Smith case:

the level of the artist's creative activity in the period preceding death; the gallery consignment agreement that authorized the gallery and others to offer for sale all items of your work owned by you; the consignment agreement requirement that the delivery of each such item of your work to us at such location as we shall indicate; and the fact that the consignment agreement was binding upon and inure to the benefit of your and our respective executors, administrators, successors and assigns.

Revenue Ruling 59-60, 65-192 and Estate Tax Regulation 20.2031-3 provide the principles to be followed in the valuation of a sole proprietorship or other closely held enterprise.

Whether you are an appraiser of personal property, business valuation, machinery and equipment or real estate,



the overall process of valuation has many of the same or similar steps.

### Approach to Value

Asset Accumulation Approach to value is the appropriate business valuation method for estimating the Fair Market Value of a sole proprietorship for the intended use of estate tax. This approach indicates the value of the business enterprise by developing a Fair Market Value balance sheet.

### How is This Done

All of the business's assets are identified and brought to the estimated Fair Market Value in Use. Therefore, in the David Smith case, the assets would be the unsold, finished works that could be sold.

Then the business's liabilities are brought to current value as of the valuation date. The liabilities would include the commissions to the gallery, the fees for establishing the sale, etc.

The difference between the Fair Market value of the assets and the current value of the liabilities is an indication of the business enterprise equity value under this approach. Equity is the ownership of the interest. In a sole proprietorship, the equity is the owner's interest.

In order to accomplish an appropriate business valuation appraisal of the David Smith estate for the intended use of estimating Fair Market Value for estate tax, the appraiser would need to be skilled in the norms and subtly nuances of the business valuation field, as well as the personal property appraisal field. The idea of re-appraising the David Smith estate is a valid area of future research for a later date.

Illustration 1





Illustration 2

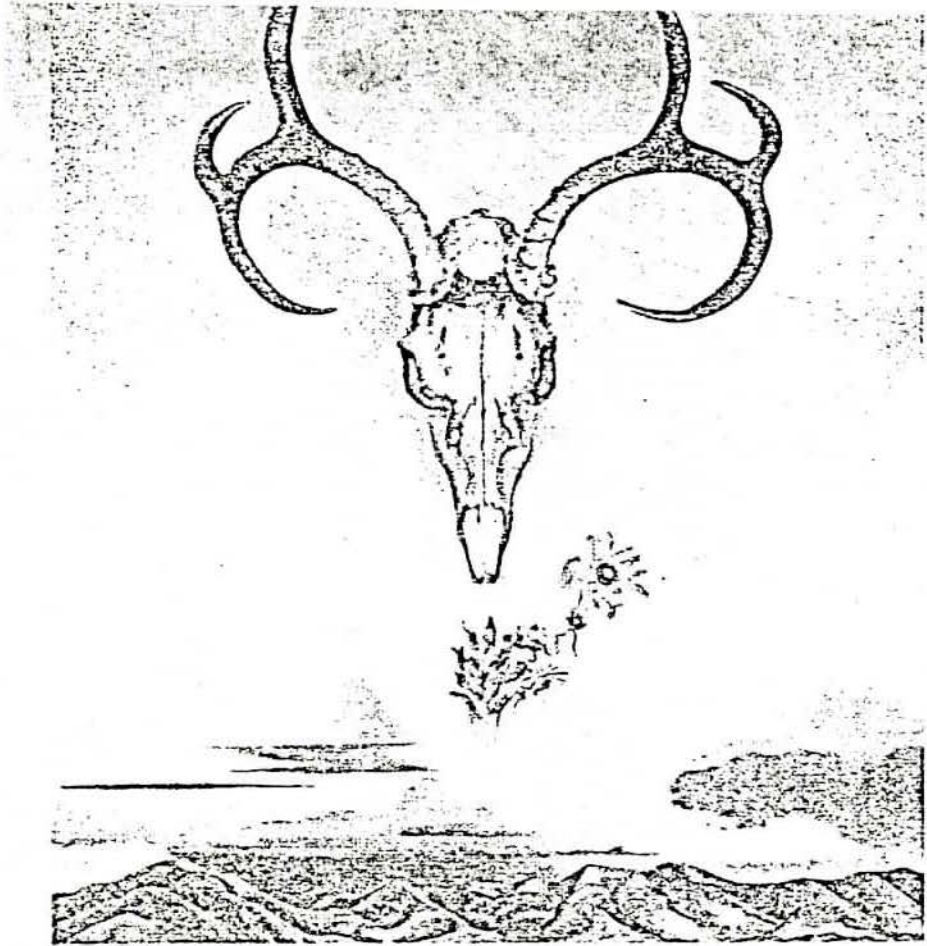


Illustration 3





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