

1975 WL 29327 (S.C.A.G.)

Office of the Attorney General

State of South Carolina

December 15, 1975

*1 Honorable Grady L. Patterson
Treasurer

QUESTION PRESENTED:

Whether securities purchased in compliance with South Carolina Code § 1-797 (1962) must continue to comply with that Section for the period of time the South Carolina Retirement System holds those securities.

STATUTES AND CASES INVOLVED:

S. C. Code Section 1-797; 3 Scotts on Trust, §§ 230, 231.

DISCUSSION:

Article 6, Section 1-797 of the Code of Laws of South Carolina (1962) dictates that the State Budget and Control Board shall receive and manage the incomes and revenues set apart and applied to the Sinking Fund of the State. That provision also prescribes the types of investment which may be made by the State Budget and Control Board for that fund and empowers such Board to hold, purchase, sell, assign, transfer and dispose of securities and investments in which the Sinking Fund is invested. Section 1-797 provides also in pertinent part:

'Investment of Funds—The State Budget and Control Board shall have full power to invest and reinvest all funds of the Sinking Fund of the State in any of the following:

(8) Obligations of any corporation within the United States if such obligations bear either of the two highest ratings of at least two nationally recognized rating services; and

(9) Obligations of any corporation incorporated in this State if such obligations bear either of the three highest ratings of at least two nationally recognized rating services . . .'

It is clear that the Budget and Control Board, in handling the State Sinking Fund acts as a trustee of such fund for the public of the State of South Carolina.

In many states there are statutes providing whether or not a trustee may or may not retain investments that are not proper investments for a trustee to make. The effect of these statutes is to establish a different rule with respect to the making and the retention of investments. The general rule regulating the conduct of a trustee in this area settles on the concept of 'prudence.' That is, the elements taken into account when rating changes are the total circumstances surrounding the retention or disposition of a 'security' at the time the rating changes. Section 230.2 of 3 Scotts Abridgment on Trusts deals with the duties of the trustee at the time of conversion. Its rules may be applicable to the similar situation in which the rating rather than trustee changes. It provides:

'Where the trust estate includes property which it is not proper for the trustee to retain in the trust, he is under a duty to dispose of it within a reasonable time. What is a reasonable time depends upon the circumstances. In the absence of

special circumstances the courts have frequently said that the usual period for the administration of an estate, a year or in some states eighteen months, is a reasonable period. This, however, is by no means a hard-and-fast rule. Under some circumstances it is imprudent to delay the conversion for so long a time. More frequently the circumstances are such that it is not imprudent to delay the sale for a longer time.

*2 The length of time during which the trustee is justified in retaining securities depends upon a variety of factors. As is stated in the Restatement of Trusts these factors may include the following: '(1) the character of the property and the amount of risk involved in its retention; (2) the amount which the trustee would receive on an immediate sale as compared with what he reasonably regards as its intrinsic value; (3) the amount which the trustee would receive on an immediate sale as compared with the value of the property at the time when it became a part of the trust estate; (4) the original value of the trust estate as a whole; (5) the general state of the market, as for example whether the prevailing prices are generally considered unduly low as in the case of a general depression or are considered unduly high; (6) the available opportunities for reinvestment; (7) the question of incurring tax liabilities; (8) the purposes of the trust and the effect thereon of a possible loss on the investment in question.'

In some cases the trustee has been held not subject to a surcharge although he did not dispose of the securities for several years after the death of the testator. In these cases it was held that the trustee reasonably believed that an earlier sale would have resulted in an unnecessary sacrifice of values, although in the actual event the securities fell further in value and a greater loss was incurred than if the trustee had sold the securities earlier. It was held that the trustee had exercised proper care under the circumstances. On the other hand, where the securities are highly speculative and where it is possible to dispose of them at a fair price, the trustee is subject to a surcharge if he fails promptly to dispose of them.'

That Section also provides:

'Where the trustee is under a duty to dispose of such a large block of securities of a single issue that they cannot be absorbed immediately by purchasers without depressing the market, he can properly sell them in small lots from time to time, although the result is an increased delay in disposing of them. A similar problem arises where owing to conditions of general depression the securities in many trusts become improper as trust investments. In that case if all the trustees are under a duty to sell immediately, the result is to force a great decline in market values. In such a case a trustee can properly postpone a sale of the securities for a longer time than he would otherwise be justified in doing. The danger of forcing such a decline is particularly great where there are statutory requirements as to what are proper trust investments. Thus where it is provided by statute that railroad bonds are proper trust investments only if dividends are paid on the shares of the railroad, and a railroad passes a dividend, the bonds of the railroad immediately cease to be proper trust investments.'

Section 231. 'Investments Subsequently Becoming Improper' of Scotts also defines the conduct expected of the trustee in situations similar to those in which members of the Budget and Control Board may be placed:

*3 'A trustee is under a duty not only to dispose of securities which are not proper trust investments when he receives them at the time of the creation of the trust, but also to dispose of securities which, although proper trust investments originally, later cease to be so. The duty to convert is applicable both where by statute or decision the trustee is limited to certain types of investment and the securities which he received as a part of the trust estate or which he subsequently purchased have ceased to be of the proper type, and also where he is not so limited but the securities have ceased to be such as a prudent man would purchase.

The mere fact that when the trustee receives or makes an investment it is a proper trust investment does not relieve him of all further responsibility. He is under a duty to see whether it continues to be a proper trust investment. Ordinarily he need not make as complete an investigation as he was under a duty to make originally, and he need not watch the ticker as a speculator would. It is his duty, however, from time to time to examine the state of the investments to see whether any of them have become such that it is no longer proper to retain them.

Where the investments, although they were proper trust investments when received by the trustee, whether he received them as original investments constituting a part of the trust estate at its inception or whether he subsequently acquired them by purchase, have ceased to be proper investments, it becomes the duty of the trustee to dispose of them within a reasonable time. What is a reasonable time depends upon the circumstances. The question is much the same as in the case where the trustee is under a duty to convert investments which were not proper trust investments at the time when he received them.

The question of the duty of the trustee to dispose of securities may arise not only where the securities have fallen in value but also where they have risen in value. In each case it is his duty to consider whether in view of the circumstances there is danger that they will subsequently fall in value. The question has been raised whether a trustee is liable for failing to sell shares of stock before the precipitate decline which took place in the fall of 1929. It later became clear that the market price of shares of stock during the earlier months of 1929 was so inflated that a fall in value was inevitable. It might now be thought that a reasonable person should have foreseen what was to happen. The fact of the matter is, however, that it was not foreseen by the great majority of reasonably cautious investors. As in all cases where it is charged that a trustee acted imprudently, his conduct is to be judged as of the time when he acted and not in the light of subsequent events.

In determining whether or not to sell securities, the trustee can properly and should give consideration to the tax consequences of a sale.

Diversification. As we have seen, it is held in a number of states that the trustee is under a duty to distribute the risk of loss by a reasonable diversification of investments, and that this principle is applicable not only to the making of investments but also to the retention of investments made by the settlor. It has been held, however, that a trustee is not under a duty to sell shares of stock which had been owned by the settlor merely because after the creation of the trust they so rose in value that they came to constitute a large proportion of the total estate.' See [North Adams National Bank v. Curtiss](#), 278 Mass. 471 180 N.E. 217 (1932).

***4** Generally, however, the trend appears to favor an 'expressed', rather than 'implied' duty if the trustee is to retain investment after a rating drops.

'Except as otherwise provided by the terms of the trust, if the trustee holds property which when acquired by him was a proper investment, but which thereafter becomes an investment which would not be a proper investment for the trustee to make, it becomes the duty of the trustee to the beneficiary to dispose of the property within a reasonable time.'

In several states there are statutory provisions authorizing the retention of such investments. In many of these cases there is the stipulation that the authorization must be by court order. Among those states are Tennessee, Texas, Virginia, and Kentucky, but not South Carolina. Consequently it appears that absent specific statutory authorization to the contrary, the trustee in South Carolina may not retain the lower-rated securities. Assuming that the State Budget and Control Board may be placed in the status of 'trustee' subject to the laws regulating the conduct of trustees, then the Board may not retain such investment securities.

In many occasions the duty of trustees in regards to retention of fallen investments outlined in the trust agreement itself: '§ 230.1. Terms of the trust. By the terms of the trust the trustee may be directed or permitted to retain securities which it would otherwise be his duty to dispose of as not being proper trust investments. If he is directed to retain them, he is not only justified in retaining them so that he is under no liability even though they depreciate in value, but he is subject to liability if he disposes of them and they subsequently rise in value. Where he is authorized but not directed to retain the securities, it is within his discretion either to retain them or to dispose of them. In neither event will he incur any liability unless he is guilty of an abuse of discretion.

The mere fact, however, that there is a provision in the terms of the trust authorizing the trustee to retain securities in which the testator had invested does not justify him in retaining them if such retention becomes imprudent. In such a case the trustee has not only a power but a duty to sell them. Ordinarily, a trustee can properly sell securities which are not proper trust investments without applying to the court for permission to do so, even though a power of sale is not conferred by the terms of the trust. Even though he is directed to retain certain securities, he is not necessarily justified in retaining them. In such a case it may be suggested that the trustee has no power of sale and that it cannot be his duty to do that he has no power to do. The answer is, of course, that it is his duty to apply to the court for permission to sell, if the circumstances are such that it becomes imprudent to retain them.' 3 Scotts.

Further:

'Any delay in the sale of securities which are not proper trust investments involves, to be sure, a certain element of risk. Although the trustee may reasonably believe that the securities will rise in price, there is always the chance that they may fall. For this reason the securities are not proper securities for the trustee to purchase for the trust. It is arguable that since the purchase would be speculative the retention is equally speculative, and that the trustee should be under a duty to sell them immediately. The courts, however, have very wisely refused to take this position. In a number of cases the court has pointed out that a trustee may be justified in retaining securities already in the trust although he would not be justified in making an investment in such securities. In considering whether the trustee is subject to a surcharge for a delay in selling securities the courts have laid some stress on the question whether they could have been sold at a price at least equal to the inventory value. Although this is a circumstance of some relevancy, it is ordinarily not determinative. The trustee may be liable for failing to sell even though he could not have sold for a price equal to the inventory value. The mere fact that a sale would involve a loss to the estate is not necessarily a justification for the failure to sell. On the other hand, the trustee is not necessarily liable for failing to sell even though he could have sold for a price equal to the inventory value. The mere fact that a sale would involve a loss to the estate does not necessarily make the trustee liable for a failure to sell although a loss subsequently ensues. He may be justified in believing that when the securities were received in the trust the price was must less than the intrinsic value.' 3 Scotts—§ 230.2

*5 Cases that have dealt with the trustee's conduct regarding the handling and disposition of investments that have become improper generally have charged the loss against the trustee for the depreciation of the securities upon a finding that the trust was held for too long a period after it began depreciating. In fact, a Massachusetts case held in 1943 that where property coming to the testamentary trustee from testator is not such property as the court would authorize the trustee to purchase, the property should be converted. Further, that case held that the trustee seeking to be allowed for a loss on an investment has the burden of proving that the trustee has exercised reasonable prudence in making or in retaining the investments. Also:

'When executor, who acted as trustee on refusal of trustee named in will to qualify, retained securities of testator, consisting of mining stocks, wasting investments and other speculative holdings which were improper for trust investment and were constantly depreciating in value, after expiration of year from date of executor's appointment, but adult legatees had requested executor to so act, executor would be charged with the proportion of the total loss resulting from executor's conduct which would otherwise force on minor legatees who were remaindermen of the trust created by the will, with simple interest from date of life beneficiary's death to date of final decree after rescript.' McInnes v. Whitman, 46 N.E.2d 527.

CONCLUSION:

Since the State Budget and Control Board falls within the definition of 'Trustee' and is consequently subject to the prevailing law and practices regarding such status then the 'Prudent Man' concept is applicable and regulatory of such Board's conduct. Specifically, whether that Board may continue to invest the funds of the South Carolina Retirement

System in securities purchased in compliance with South Carolina Code Section 1-797 (1962) after the requisite rating drops below standard, it appears that such Board must dispose of such securities within a reasonable time. 'Reasonable time' as shown depends upon a number of elements. However, the securities must be disposed of and those funds resulting from the sale must be reinvested.

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