Calif. Ruling May Open Bankruptcy Trustees To Tort Liability

By **Jarrett Osborne-Revis** (November 6, 2023)

Jarrett Osborne-Revis

The California Second District Court of Appeal decided a case in October that could reverberate throughout the receivership and bankruptcy industries.

The case, Breanne Martin v. Leslie Gladstone, comes at an inopportune moment as bankruptcy proceedings and receiverships — particularly for distressed commercial real estate entities — trend upward in California.

Receivers and bankruptcy trustees alike in California should consider this case before operating a commercial real estate distressed entity.

Bankruptcy Trustee Sued

The case originated from Christopher Dougherty and Nereida Dougherty's Chapter 11 bankruptcy proceeding.[1]

The U.S. Bankruptcy Court for the Southern District of California later converted the Doughertys' bankruptcy case to Chapter 7 and appointed a Chapter 7 trustee, Leslie Gladstone.[2] Soon after appointing the trustee, the bankruptcy court put the Doughertys' operating entity, JTA Real Estate Holdings LLC, and its real property assets in the Dougherty's bankruptcy estate.[3]

Consistent with the trustee's obligation to maximize the estate's value and liquidate its assets, the trustee sought to operate and maintain temporarily JTA's properties until liquidation.[4]

The trustee quickly realized though that one of JTA's assets, a residential rental property in Alpine, California, was too burdensome to the estate.[5] The Alpine property, as the trustee concluded, lacked equity and had numerous uncorrected code violations that would have burdened the estate to fix.[6]

Two days after the trustee sought to abandon the Alpine property to JTA, a large metal gate at the Alpine property injured Breanne Martin.[7] Martin sued the trustee, asserting claims for negligence and premises liability.[8]

The trial court dismissed Martin's claims against the trustee, and Martin appealed.[9]

Court of Appeal Reversal

The Martin court first considered if the trustee was immune from the plaintiff's claims because the trustee had abandoned the Alpine property retroactively to the Doughertys' bankruptcy filing date.

As the Martin court explained, when a trustee abandons estate property, "ownership and control of the asset is reinstated in the debtor with all rights and obligations before filing a petition in bankruptcy."[10] Thus, the Martin court focused on the retroactive effect of the trustee's abandonment.

The trustee claimed the abandonment did more than just revert the Alpine property to the Doughertys: It "operated as if the Doughertys retained … the Alpine Property, without interruption, throughout ... the bankruptcy case."[11] The Martin court disagreed.

After canvassing bankruptcy cases nationwide, the Martin court believed that the trustee's automatic retroactive abandonment theory went too far. In the Martin court's view, the retroactive abandonment principle is not absolute; it applies only in those situations where justice requires it.[12]

The Martin court found no case where a court at the pleading stage applied abandonment retroactively to relieve a trustee of liability for injuries sustained on the bankruptcy estate property.[13] Comforted by this dearth of cases, the Martin court rejected the legal fiction of relation back abandonment because it would have caused an unfair result — potentially leaving Martin without a judicial remedy.[14]

The trustee's retroactive abandonment theory also would have frustrated California's policy of requiring those who exert control over property to ensure that such property remains reasonably safe.[15] Under the trustee's theory, she would have had no duty to take steps "to prevent harm from occurring on" the Alpine property even though she still controlled it when the plaintiff's injuries occurred.

The Martin court rejected this perceived unjust outcome. Because the plaintiff's injuries occurred before the trustee effectuated the abandonment, the trustee's abandonment did not absolve her from liability for the plaintiff's injuries.

The Martin court next addressed the trustee's fallback position that the trial court rightly dismissed the plaintiff's claims because she did not satisfy the Barton doctrine.[16] In Barton v. Barbour in 1881, the U.S. Supreme Court held that an aggrieved party, before filing a lawsuit against a receiver or a trustee, must obtain the appointing court's consent.[17]

Congress, through subsequent legislation, narrowed this protection for receivers and trustees.[18] Under Title 28 of the U.S. Code, Section 959(a), aggrieved parties may sue "trustees, receivers, or managers of any property" for claims regarding "any of their acts or transactions in carrying on business connected with such property."[19]

Section 959 preserves the Barton doctrine for an aggrieved party's claims against a trustee or receiver for actions consistent with preserving and liquidating the estate.[20] But if an aggrieved party challenges a trustee's or a receiver's conduct in operating the debtor's business, the aggrieved party need not obtain the appointing court's consent to pursue such claims.[21]

Relying on bankruptcy cases nationwide limiting the Barton doctrine in similar scenarios, the Martin court declined to apply it to the plaintiff's claims at the pleading stage.[22] The plaintiff's complaint alleged that the trustee "owned, leased, occupied, maintained, or controlled" the Alpine Property as landlord during the relevant period.[23]

The trustee's request to operate the Doughertys' business and her monthly reports to the bankruptcy court supported this allegation.[24] Those documents allegedly showed that the trustee was "carrying on an ongoing rental business connected with the premises" when the plaintiff suffered her injuries.[25]

Thus, the Martin court concluded that the plaintiff could maintain her claims against the trustee in state court.[26]

Lessons From Martin

The Martin court tried to protect the plaintiff from a perceived Catch 22 — in which the debtor disclaims liability because the accident happened while the trustee controlled the estate property, and the trustee contests liability because she had retroactively abandoned the estate property.

Invoking equity, the Martin court allowed the plaintiff to pursue her claims against the trustee outside the bankruptcy court. Bankruptcy trustees and federal receivers in California should be aware of Martin when operating a commercial property in California.[27]

First, Martin's application of tort concepts to bankruptcy trustees could pose a new concern for bankruptcy trustees and federal receivers when controlling and maintaining a commercial property. In rejecting retroactive abandonment, the Martin court leaned on California's policy that "whoever has the means to control the property also has the ability to take reasonable steps to prevent harm."[28]

The Martin decision may lead one to conclude that a bankruptcy trustee or a federal receiver that operates a commercial property must use estate funds to protect the property from unsafe conditions.

The facts in Martin, however, exemplify a problem with this approach: The Alpine property was underwater, and generated insufficient proceeds to service the preexisting debt and cover maintenance and remedial costs.

The trustee tried to abandon this burdensome property, but the abandonment occurred only after the plaintiff sustained her injuries. Thus, after Martin, a bankruptcy trustee or a federal receiver in California intending to operate a commercial property may need to consider investigating estate real property for any unsafe conditions before operating it.

Second, Martin could lead courts to apply bankruptcy abandonment inconsistently.

Martin acknowledged that a "court may rely on the fiction that title to property abandoned by a trustee remained with the debtor as if the bankruptcy petition had never been filed in situations in which equity requires the application of the nunc pro tunc fiction."[29]

Martin declined to apply relation back abandonment for the trustee's benefit. Another court faced with similar facts also may follow Martin and decline to apply this legal fiction of relation back abandonment to the debtor's petition date.

That outcome though could create an anomalous result for the debtor defendant: The debtor could try to avoid liability for the plaintiff's injuries that occurred at the property while the trustee operated and maintained it.

In that scenario, the court may need relation back abandonment to ensure that the debtor "has all of the responsibilities and liabilities that result from [property] ownership, including those that result if the property continues to be unsafe and dangerous."[30]

Third, Martin may lead courts to overemphasize the effect of a bankruptcy trustee's decision to operate a debtor's business. The Martin court stressed the trustee's decision

unequivocally showed that the trustee went beyond "the mere administration of property" and operated the Alpine property like the Doughertys' prebankruptcy.

The trustee's decision, however, was consistent with the trustee's principal duty to "collect and reduce to money property of the estate."[31] The bankruptcy court authorized the trustee to operate the Doughertys' business for a limited time and consistent with an orderly liquidation.

The trustee undertook this task early to preserve the business assets while the trustee sought to market them. That function should have been incidental to preserving the Doughertys' business assets — a result that ordinarily should have triggered the Barton doctrine.

Lastly, if the Barton doctrine does not apply when a bankruptcy trustee or a federal receiver operates a debtor's business, both court-appointed officials could still claim immunity from an aggrieved party's claims.

Along with the Barton doctrine's common law procedural immunity, bankruptcy trustees and receivers enjoy substantive immunity from third-party tort suits under quasi-judicial immunity.[32] This immunity protection, recognized by the Supreme Court in 1891 in McNulta v. Lochridge, extends to third-party suits against either court-appointed official "for actions taken in his official capacity."[33]

If the immunity defense applies, the bankruptcy trustee or receiver would not be personally liable in third-party suits; such suits would instead lie against the bankruptcy estate or receivership.[34]

The Martin court did not address or purport to decide the trustee's potential immunity to the plaintiff's claims at the pleading stage — it may now surface on remand. Stay tuned to see how Martin unfolds.

Jarrett Osborne-Revis is senior counsel at Buchalter APC.

[1] Breanne Martin v. Leslie Gladstone, Case No. D080534, 2023 WL 6889015, at *2 (2023).

[2] Id. at *3.

[3] Id.

[4] Id. at *3-4.

[5] Id. at *4.

[6] Id.

[7] Id. at *5.

[8] Id.

[9] Id. at *7.

[10] Id. at *10-11 (citing In re Franklin Signal Corp., 65 B.R. 268, 274 (Bankr. D. Minn. 1986)).

[11] Breanne Martin, 2023 WL 6889015, at *11.

[12] Id. at *12.

[13] Id. at *14.

[14] Id. at *18-19.

[15] Id.

[16] Id. at *19.

[17] Id. at *20-21 (citing Harris v. Wittman (In re Harris), 590 F.3d 730, 741 (9th Cir. 2009)).

[18] Breanne Martin, 2023 WL 6889015, at *10.

[19] Id. at *21.

[20] Id. at *22-23 (citing In re VistaCare Group, LLC, 678 F.3d 218, 225-26 (3d Cir. 2012)).

[21] Breanne Martin, 2023 WL 6889015, at *22 (citing In re VistaCare Group, LLC, 678 F.3d at 225-26).

[22] Id at *27.

[23] Id.

[24] Id.

[25] Id.

[26] Id.

[27] A California state court receiver, unlike a bankruptcy trustee or a federal receiver, might argue that Martin minimally impacts state court receiverships. Section 959's exception to the Barton doctrine generally applies to bankruptcy trustees and federal receivers, not state court receivers. Republic Bank of Chicago v. Lighthouse Mgmt. Grp., Inc., 829 F. Supp. 2d 766, 773 (D. Minn. 2010); accord Freeman v. County of Orange, Case No. SACV 14-107-JLS, 2014 WL 12668679, at *4 (C.D. Cal. May 29, 2014).

[28] Breanne Martin, 2023 WL 6889015, at *28 (citing Soto v. Union Pacific Railroad Co., 45 Cal. App. 5th 168, 177 (2020)).

[29] Breanne Martin, 2023 WL 6889015, at *28

[30] In re Flood, 234 B.R. 286, 292-93 (Bankr. W.D.N.Y. 1999).

[31] See 11 U.S.C. § 704(a)(1).

[32] See In re J&S Prop., LLC, 872 F.3d 138, 150 (3rd Cir. 2017) (Fisher, J. concurring) (recognizing that equity receivers and bankruptcy trustees have procedural and substantive immunities from suits by third parties).

[33] Id. at 151.

[34] Id.; see also Smith v. Martin, 542 F.2d 688, 691 (6th Cir. 1976) (finding "no personal liability for receiver who did not either outside their authority under court order or maliciously or corruptly.").