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# Bankruptcy Law

# BANKRUPTCY LAW

## I. DEBTOR'S INTEREST IN AN ERISA-QUALIFIED PENSION PLAN EXCLUDED FROM THE BANKRUPTCY ESTATE

In *Anderson v. Raine (In re Moore)*[1] the Fourth Circuit Court of Appeals held that a debtor's bankruptcy estate does not include interests in a plan qualified under the Employment Retirement Income Security Act of 1974 (ERISA).[2] The court's decision conflicts with the decisions of other circuit, district, and bankruptcy courts that have considered this issue.

The trustee for the estates of several Chapter 7 debtors employed by Springs Industries, Inc. (Springs) brought suit against the administrator of Springs' pension and profit-sharing plan (the Plan). The debtors participated in the Plan, which contained antiassignment provisions that prohibit the employees from alienating their interests in the Plan. ERISA requires these provisions to qualify the Plan for tax-exempt status.[3] The Plan also prohibited the distribution of vested interests to a beneficiary until after retirement, disability, or termination of services by the participant.[4]

The bankruptcy trustee argued that the debtors' interests in the Plan are property of the estate pursuant to section 541(a)(1) of the Bankruptcy Code.[5] This section broadly defines a debtor's estate as "all legal or equitable interests of the debtor in property as of the commencement of the case."[6] The administrator sought, however, to enforce the antialienation provisions of the Plan against the trustee. The administrator based his argument on the exclusionary provision of section 541(c)(2), which provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under *applicable nonbankruptcy law* is enforceable in a case under this title."[7] Accordingly, the administrator argued that "the restrictions on

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1. 907 F.2d 1476 (4th Cir. 1990).

2. 29 U.S.C. §§ 1001-1461 (1988 & Supp. I 1989), *as amended by* Pub. L. No. 101-58, 104 Stat. 1388 (1990).

3. *See infra* notes 21-22 and accompanying text.

4. *Anderson*, 907 F.2d at 1477. The court noted that at the time of litigation "[t]he debtors have thus far received no distribution under the plans and will not be eligible to do so in the near future." *Id.*

5. 11 U.S.C. § 541(a)(1) (1988).

6. *Id.*

7. *Id.* § 541(c)(2) (emphasis added).

alienation of plan benefits in ERISA constitute 'applicable nonbankruptcy law' which operates under § 541(c)(2) to exclude the debtors' interests in this ERISA-qualified plan from their bankruptcy estates."[8]

The trustee challenged the administrator's position and argued that the debtors' interests were not excludable because the term "applicable nonbankruptcy law" refers only to plans with antialienation provisions enforceable under state spendthrift trust law. The trustee alleged that the Plan failed to qualify as a valid spendthrift trust under South Carolina law. The trustee argued, therefore, that the debtors' interests are not protected by section 541(c)(2) and are property of the debtors' estates.[9]

The bankruptcy court disagreed with the trustee and "held that because the plan was ERISA-qualified, the interests in it were nonalienable and thus were excluded from the bankruptcy estates and not subject to turnover to the trustee."[10] The district court affirmed. The trustee appealed the judgment of the district court. The Fourth Circuit affirmed.[11]

In reaching its decision, the Fourth Circuit addressed two issues. First, the court determined the meaning of the term "applicable nonbankruptcy law." Second, the court decided whether ERISA's transfer restriction brings ERISA within the meaning of the term.

With respect to the definition of the term "applicable nonbankruptcy law," the court had two choices: adopt the trustee's narrow interpretation that limits section 541(c)(2)'s application to state spendthrift trust law or accept the administrator's broader interpretation. The *Anderson* court adopted the broader interpretation and reasoned that " '[a]pplicable nonbankruptcy law' means precisely what it says: all laws, state and federal, under which a transfer restriction is enforceable. Nothing in the phrase . . . or in the remainder of § 541(c)(2) suggests that the phrase refers exclusively to state law, much less to state spendthrift trust law."[12]

The court reached its decision, in part, by looking to other Bankruptcy Code sections in which the term "applicable nonbankruptcy law" is used. The court observed that interpretations of the term in other sections encompass both state and federal law.[13] The court then concluded that " 'a word is presumed to have the same meaning in all subsections of the same statute.' "[14] Additionally, the court relied on

8. *Anderson*, 907 F.2d at 1477 (citation omitted).
9. *Id.*
10. *Id.*
11. *Id.* at 1481.
12. *Id.* at 1477.
13. *Id.* at 1477-78.
14. *Id.* at 1478 (quoting Morrison-Knudson Constr. Co. v. Director, Office of Work-

its decision in *McLean v. Central States, Southeast & Southwest Areas Pension Fund.*[15]

Although the *McLean* court did not decide whether ERISA is "applicable nonbankruptcy law," it "rejected the contention that '§ 541(c)(2) should be confined in its recognition of enforceable transfer restrictions to those found in "traditional" spendthrift trusts.' "[16] The court also reasoned that if courts rely solely upon state spendthrift trust law, states that fail to recognize state spendthrift trusts could completely disregard the ERISA antialienation provisions. This result is contrary to Congress's intent that ERISA completely pre-empt state law.[17]

After defining the scope of "applicable nonbankruptcy law," the *Anderson* court determined "whether ERISA contains an enforceable transfer restriction that would bring [ERISA] within the meaning of the term 'applicable nonbankruptcy law' in § 541(c)(2)."[18] In answering this question affirmatively, the court focused on its interpretation of both ERISA and the Bankruptcy Code and attempted to give full effect to both statutes.[19] The Bankruptcy Code broadly defines an estate in bankruptcy to include "all legal or equitable interests of the debtor in property as of the commencement of the case."[20] In contrast, ERISA requires plans to include provisions that prohibit the alienation of interests in the plans before they qualify under ERISA.[21] Additionally, the Internal Revenue Code and the accompanying Treasury Regulations contain assignment restrictions.[22] Thus, if a court includes the debtor's interest in a plan in the bankruptcy estate, compliance with all of these statutes is impossible.[23] Accordingly, the court determined

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ers' Compensation Programs, 461 U.S. 624, 633 (1983)).

15. 762 F.2d 1204 (4th Cir. 1985).

16. *Anderson*, 907 F.2d at 1478 (quoting *McLean*, 762 F.2d at 1207 n.1).

17. *Id.* at 1480 (citing 29 U.S.C. § 1144(a) (1988)). Section 1144(a) provides, with some exceptions, that "this chapter shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. § 1144(a) (1988).

18. *Anderson*, 907 F.2d at 1479.

19. *Id.* In Morton v. Mancari, 417 U.S. 535 (1974), the Court stated, "The courts are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Id.* at 551.

20. 11 U.S.C. § 541(a)(1) (1988).

21. Section 1056(d)(1) of ERISA states, "Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated." 29 U.S.C. § 1056(d)(1) (1988).

22. *Anderson*, 907 F.2d at 1480 (discussing the relevant portions of the Internal Revenue Code and the Treasury Regulations).

23. *See* Seiden, *Chapter 7 Cases: Do ERISA and the Bankruptcy Code Conflict as to Whether a Debtor's Interest in or Rights Under a Qualified Plan Can Be Used to Pay Claims? (pt. 2)*, 61 AM. BANKR. L.J. 301, 317 (1987).

that it could "best harmonize ERISA, the Bankruptcy Code, and the Internal Revenue Code by reading 'applicable nonbankruptcy law' to include ERISA."[24]

The *Anderson* court also recognized that its holding prevents general creditors from circumventing a plan's antiassignment restrictions by forcing a debtor into involuntary bankruptcy.[25] Moreover, if the *Anderson* court had approved a violation of the antialienation provision by allowing turnover of a single debtor's interest, the entire Plan would have lost its tax-exempt status.[26] Disqualification of a plan's tax-exempt status affects not only the debtor, but also employers, other plan participants, and the trust itself.[27] Finally, the *Anderson* court recognized that its decision to construe ERISA as "applicable nonbankruptcy law" furthered ERISA's policy of protecting a worker's defined retirement benefits.[28]

Decisions from other jurisdictions differ on the interpretation of section 541(c)(2)'s exclusionary provision. A minority of decisions use reasoning similar to the *Anderson* court's and hold that ERISA constitutes "applicable nonbankruptcy law."[29] However, a greater number of circuit, district, and bankruptcy courts focus on state spendthrift trust law when applying section 541(c)(2) to retirement plans.[30]

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24. *Anderson*, 907 F.2d at 1481 (citation omitted). The court's holding is one of three potential resolutions of this issue. Seiden, *supra* note 23, at 317-19. Once the court decided the issue, it noted that it did not need to "reach the question whether the plan constitutes a spendthrift trust under South Carolina law." *Anderson*, 907 F.2d at 1477.

25. *Anderson*, 907 F.2d at 1480.

26. *Id.* at 1480-81. The Internal Revenue Service has expressly stated that a plan will lose its tax-exempt status if the plan administrator turns over the assets of the plan to the bankruptcy trustee. *See* Priv. Ltr. Rul. 90-11-037 (Dec. 20, 1989); Priv. Ltr. Rul. 89-51-067 (Sept. 28, 1989); Priv. Ltr. Rul. 89-10-035.

27. Seiden, *supra* note 23, at 333-34.

28. *Anderson*, 907 F.2d at 1479-80.

29. Forbes v. Lucas (*In re* Lucas), 924 F.2d 597 (6th Cir. 1991) (expressly following *Anderson* approach); *Anderson*, 907 F.2d at 1478 (citing Liscinski v. Mosely (*In re* Mosley), 42 Bankr. 181 (Bankr. D.N.J. 1984); Warren v. G.M. Scott & Sons (*In re* Phillips), 34 Bankr. 543 (Bankr. S.D. Ohio 1983); Clotfelter v. Ciba-Geigy Corp. (*In re* Threewitt), 24 Bankr. 927 (D. Kan. 1982)). *But see In re* Lee, 119 Bankr. 833 (Bankr. M.D. Fla. 1990) (expressly rejecting the *Anderson* approach); *In re* Martin, 119 Bankr. 297 (Bankr. M.D. Fla. 1990) (expressly rejecting the *Anderson* approach).

30. *See, e.g.*, *In re* Perkins, 902 F.2d 1254 (7th Cir. 1990); Humphrey v. Buckley (*In re* Swanson), 873 F.2d 1121 (8th Cir. 1989); Brooks v. Interfirst Bank (*In re* Brooks), 844 F.2d 258 (5th Cir. 1988); Daniel v. Security Pac. Nat'l Bank (*In re* Daniel), 771 F.2d 1352 (9th Cir. 1985), *cert. denied*, 475 U.S. 1016 (1986); Lichstrahl v. Bankers Trust (*In re* Lichstrahl), 750 F.2d 1488 (11th Cir. 1985); Regan v. Ross, 691 F.2d 81 (2d Cir. 1982); *see also* Seiden, *supra* note 23, at 245-54 (providing an excellent discussion of the decisions that focus on state spendthrift trust law when deciding whether to exclude from the bankruptcy estate a debtor's interest in an ERISA-qualified pension plan).

Even if a court limits the application of section 541(c)(2) to state spendthrift trust

Section 541(c)(2) does not mention state spendthrift trust law. Consequently, many of the courts that follow the spendthrift trust theory support their position with the legislative reports that accompany section 541(c)(2).[31] The legislative history arguably establishes Congressional intent that section 541(c)(2) applies only to antialienation provisions enforceable under state spendthrift trust law. The *Anderson* court concluded, however, that because the language of the statute is clear and unambiguous, the legislative history is irrelevant.[32]

The *Anderson* court's broad reading of section 541(c)(2) was proper. This interpretation harmonizes the potential conflicts between the Bankruptcy Code, ERISA, the Internal Revenue Code, and the Treasury Regulations and avoids a potential conflict with the pre-emption provisions of ERISA. Although it may appear inequitable to bar a debtor's assets from creditors, these inequities are outweighed by the adverse effects a different result would have on innocent plan participants. The *Anderson* court recognized and resolved these problems, but deepened the split between circuits on this issue. Until the Supreme Court decides the issue, however, the law in the Fourth Circuit is clear: pursuant to section 541(c)(2) of the Bankruptcy Code, a debtor's interest in an ERISA-qualified plan is excluded from that debtor's bankruptcy estate.

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## II. FOURTH CIRCUIT INTERPRETS THE SUBSEQUENT ADVANCE RULE OF BANKRUPTCY CODE SECTION 547(c)(4) TO ALLOW SETOFF AGAINST ALL PRIOR PREFERENTIAL PAYMENTS

In *Crichton v. Wheeling National Bank* (*In re Meredith Manor, Inc.*)[33] the Fourth Circuit Court of Appeals interpreted section 547(c)(4) of the Bankruptcy Code[34] to allow a creditor to setoff advances to the debtor not only against an immediately preceding preferential payment but also against all prior preferential payments.[35] Thus, a bankruptcy trustee must calculate the amount recoverable as prefer-

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law, a debtor could argue that an ERISA-qualified plan meets the requirements of the state law. However, ERISA plans usually do not meet the rigid requirements of a valid state spendthrift trust. For example, the settlor may be the beneficiary, the plan may contain certain loan or withdrawal provisions, or the settlor may have absolute domain over the trust. *See, e.g.*, *Lichstrahl*, 750 F.2d at 1490.

31. *See Anderson*, 907 F.2d at 1478-79.

32. *Id.* (citing Davis v. Michigan Dep't of the Treas., 489 U.S. 803, 809 n.3 (1989)).

33. 902 F.2d 257 (4th Cir. 1990).

34. 11 U.S.C. § 547(c)(4) (1988).

35. *Crichton*, 902 F.2d at 259.

ences by determining the difference between total preferences and total advances, provided that each advance is used to offset only prior preferences.[36]

"[S]ection 547(c)(4) is Congress' solution for the running account creditor"[37] and prohibits the trustee from recovering a preference if "(1) the creditor extended new value to or for the benefit of the debtor, (2) that new value was unsecured, (3) the extension induced an 'otherwise unavoidable transfer' from debtor to creditor, and (4) the extension occurred 'after such transfer.' "[38] The *Crichton* decision interpreted the meaning of the fourth requirement and is significant for two reasons: consistent with other circuits, the Fourth Circuit implicitly rejected the view that section 547(c)(4) codifies the net result rule,[39] and the Fourth Circuit squarely addressed whether section 547(c)(4) allows a creditor to carry forward a debtor's preferential payments until exhausted by subsequent advances to the debtor.

In *Crichton* the debtors obtained a $200,000 line of credit from Wheeling National Bank in May 1985. As security, the debtors granted the Bank a security interest in all current and after acquired accounts receivable and in student contracts arising from the debtors' operation of a horsemanship school.[40] In mid-November 1985 the creditors called the line of credit, and on November 21, 1985, the debtors filed petitions under Chapter 7 of the Bankruptcy Code.[41]

In the bankruptcy court proceeding the trustee requested that the court allow him to recover, as preferential payments, all loan repayments the debtors made to the Bank during the ninety days preceding the filing of the bankruptcy petition.[42] The Bank conceded that the payments it received from the debtors were preferential transfers

36. *Id.* Under the Bankruptcy Code a trustee may recover a transfer to a creditor that meets the voidable preference requirements defined in section 547(b). 11 U.S.C. § 547(b) (1988). The trustee may not, however, avoid such a transfer if a section 547(c) exception applies. *Id.* § 547(c). Congress enacted section 547(c)(4) to "remove[] the unfairness of allowing the trustee to void all transfers made by the debtor to a creditor during the preference period without giving the creditor any corresponding credits for subsequent advances of new value to the debtor's estate." 4 COLLIER ON BANKRUPTCY § 547.12, at 56 (15th ed. 1990).

37. 4 COLLIER ON BANKRUPTCY, *supra* note 36, at 57.

38. Comment, *The Running-Account Creditor and Section 547(c)(4) of the New Bankruptcy Code*, 16 WAKE FOREST L. REV. 959, 962 (1980).

39. According to the Ninth Circuit, "[t]he net result rule was a judicial creation under the 1898 Bankruptcy Act. It provided that if there was a running account of credit and payment between debtor and creditor, all transactions over the preference period were examined." McClendon v. Cal-Wood Door (*In re* Wadsworth Bldg. Components, Inc.), 711 F.2d 122, 123 (9th Cir. 1983); *see* Comment, *supra* note 38, at 967-68.

40. *Crichton*, 902 F.2d at 257.

41. *Id.* at 258.

42. *Id.*

under section 547(b) of the Bankruptcy Code.[43] The Bank argued, however, that section 547(c)(4) codified the net result rule and that the trustee was, therefore, entitled to recover only $31,705.28 of the $121,659.61 in total payments received from the debtor because the Bank made advances to the debtor totaling $89,954.33 during the same period.[44] The bankruptcy court rejected the Bank's argument and held that in "[a]pplying the procedure set forth in Section 547(c)(4), each transfer by a debtor within the 90-day pre-petition preference period must be netted against the value of advances made to the debtor after that transfer *but before the next transfer.*"[45]

On appeal the district court rejected both the Bank's and the bankruptcy court's interpretation of section 547(c)(4) and held that all preferential payments made by a debtor prior to an advance may be carried forward until exhausted and netted against the value of subsequent advances.[46] Thus, the district court adopted the approach set forth in *Thomas W. Garland, Inc. v. Union Electric Co. (In re Thomas W. Garland, Inc.)*[47] and rejected the approach subsequently articulated in *Leathers v. Prime Leather Finishes Co.*[48] on which the bankruptcy court relied. The Fourth Circuit affirmed the judgment of the district court and adopted the *Garland* rule as the proper interpretation of section 547(c)(4).[49]

The Fourth Circuit reasoned that the *Garland* rule better serves the legislative goal of encouraging creditors to assist financially troub-

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43. 11 U.S.C. § 547(b) (1988).

44. Wheeling Nat'l Bank v. Meredith (*In re* Meredith Manor, Inc.), Ch. 7 Case No. 85-40149, Adv. No. 87-0097, slip op. at 5 (Bankr. S.D.W. Va. Feb. 27, 1989), *vacated and remanded*, 103 Bankr. 118 (S.D.W. Va. 1989), *aff'd sub nom.* Crichton v. Wheeling Nat'l Bank (*In re* Meredith Manor, Inc.), 902 F.2d 257 (4th Cir. 1990).

45. *Id.* at 8.

46. Wheeling Nat'l Bank v. Meredith (*In re* Meredith Manor, Inc.), 103 Bankr. 118 (S.D.W. Va. 1989), *aff'd sub nom.* Crichton v. Wheeling Nat'l Bank (*In re* Meredith Manor, Inc.), 902 F.2d 257 (4th Cir. 1990).

47. 19 Bankr. 920 (Bankr. E.D. Mo. 1982).

48. 40 Bankr. 248 (D. Me. 1984). In comparing the various interpretations of section 547(c)(4), the district court stated:

> The difference between the *Garland* and *Leathers* methods is that *Leathers* limits the preferential payment carry forward while *Garland* does not. In *Garland*, the creditor is entitled to a dollar-for-dollar offset up to the date of bankruptcy, regardless of intervening payments. *Leathers*, on the other hand, places extreme emphasis on each individual preferential payment and affords dollar-for-dollar protection only for advancements made between payments. Unlike the net result rule, both methods require the preferential payment precede the offsetting advancement for the creditor to be entitled to a set off.

*Meredith*, 103 Bankr. at 120.

49. *Crichton*, 902 F.2d at 259.

led debtors and reflects a more realistic view of commercial practices.[50] A creditor does not extend credit based upon any single payment. Instead, a creditor analyzes "the debtors' entire financial picture and repayment history, not the latest payment,"[51] when extending credit.

The Fourth Circuit's implicit holding that section 547(c)(4) does not codify the judicially created net result rule is consistent with other circuits' holdings,[52] many lower court opinions,[53] and other commentators.[54] Section 547(c)(4) is now known by most courts as the subsequent advance rule.[55] Courts have differed, however, in their interpretations of this rule, with some adopting a form of the *Garland* rule[56] and one adopting a form of the *Leathers* rule.[57]

In *Valley Candle Manufacturing Co. v. Stonitsch* (*In re Isis Foods, Inc.*)[58] the court attempted to reconcile *Garland* and *Leathers*. It argued that courts should limit the *Garland* holding to the facts of that case.[59] In *Garland* the court allowed the creditor to setoff an advance of credit against the total of three preferential payments made on the same day without intervening extensions of credit.[60] The *Stonisch* court noted that the *Leathers* court allowed the creditor to

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50. *Id.*

51. *Id.*

52. New York City Shoes v. Bentley Int'l (*In re* New York City Shoes), 880 F.2d 679, 680 (3d Cir. 1989); *In re* Prescott, 805 F.2d 719, 728 (7th Cir. 1986); McClendon v. Cal-Wood Door (*In re* Wadsworth Bldg. Components, Inc.), 711 F.2d 122, 123-24 (9th Cir. 1983); Waldschmidt v. Ranier (*In re* Fulghum Constr. Corp.), 706 F.2d 171, 173-74 (6th Cir.), *cert. denied*, 464 U.S. 935 (1983), *on remand*, 45 Bankr. 112 (Bankr. M.D. Tenn. 1984), *aff'd*, 78 Bankr. 146 (M.D. Tenn. 1987), *rev'd on other grounds*, 872 F.2d 739 (6th Cir. 1989); Gold Coast Seed Co. v. Spokane Seed Co. (*In re* Gold Coast Seed Co.), 30 Bankr. 551, 552-53 (Bankr. 9th Cir. 1983).

53. Eisenberg v. O. Censor & Co. (*In re* Baumgold Bros., Inc.), 103 Bankr. 436, 439 (Bankr. S.D.N.Y. 1989); Riezman v. Phillips Petroleum Co. (*In re* Telecommunication Servs., Inc.), 55 Bankr. 83 (Bankr. E.D. Mo. 1985); Leathers v. Prime Leather Finishes Co., 40 Bankr. 248, 250-51 (D. Me. 1984); Valley Candle Mfg. Co. v. Stonitsch (*In re* Isis Foods, Inc.), 39 Bankr. 645, 652 (W.D. Mo. 1984); Thomas W. Garland, Inc. v. Union Elec. Co. (*In re* Thomas W. Garland, Inc.), 19 Bankr. 920, 925-26 (Bankr. E.D. Mo. 1982); Pettigrew v. Trust Co. Bank (*In re* Bishop), 17 Bankr. 180, 185 (Bankr. N.D. Ga. 1982).

54. 4 COLLIER ON BANKRUPTCY, *supra* note 36, at 57-58; Comment, *supra* note 38, at 959.

55. *Prescott*, 805 F.2d at 728; *Waldschmidt*, 706 F.2d at 172-73; *Eisenberg*, 103 Bankr. at 439; *Leathers*, 40 Bankr. at 250; *Stonitsch*, 39 Bankr. at 649.

56. *Eisenberg*, 103 Bankr. at 440; *see Waldschmidt*, 706 F.2d at 173-74.

57. *Stonitsch*, 39 Bankr. at 649-52.

58. 39 Bankr. 645 (W.D. Mo. 1984).

59. *Id.* at 650.

60. *Garland*, 19 Bankr. at 929. The credit exceeded the three payments made on the same day; therefore, the court allowed the creditors to retain all three payments pursuant to section 547(c)(4). *Id.*

setoff the total value of two extensions of credit made without an intervening preferential payment against the total amount of several checks received during the period prior to the two extensions of credit.[61] The court implied that *Garland* did not contemplate allowing creditors to carry forward preferential payments in excess of a subsequent extension of credit. Therefore, the court adopted the *Leathers* rule as consistent with the construction of section 547(c)(4). Thus, the Fourth Circuit's reliance on the *Garland* rule may be unjustified.

Although the *Garland* holding did not present the factual situation addressed by the Fourth Circuit, the underlying rationale of *Garland* supports the Fourth Circuit's opinion. In *Garland* the court noted that "[a]n acknowledgement of the net result rule in the legislative history serves to emphasize that the drafters of the Code were attempting to retain at least the principles behind the rule in section 547(c)(4) and to recognize the realities of ordinary business transactions."[62] *Garland's* rationale supports the view that only one difference exists between section 547(c)(4)'s subsequent advance rule and the net result rule: only advances made subsequent to a preference may be used to offset a trustee's avoidance powers. This view would support carrying forward preferential payments until exhausted.[63]

The Fourth Circuit's approach also is consistent with section 547(c)(4)'s purpose of "encourag[ing] trade creditors to continue dealing with troubled businesses"[64] while simultaneously promoting equality of treatment among creditors. If section 547(c)(4) does not allow a creditor "to set off subsequent new value against a net balance of all prior preferences, there would be little incentive for [the creditor] to continue [advancing] any new value to the debtor in excess of the immediately preceding payment, regardless of the amount of prior payments by the debtor."[65] However, if section 547(c)(4) allows a creditor

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61. *Stonitsch*, 39 Bankr. at 651.

62. *Garland*, 19 Bankr. at 926. The legislative history of section 547(c)(4) provides: "The fourth exception codifies the net result rule in section 60c of current law. If the creditor and the debtor have more than one exchange during the 90-day period, the exchanges are netted out according to the formula in paragraph (4)." H.R. REP. No. 595, 95th Cong., 1st Sess. 374 (1977), *reprinted in*, 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6330; S. REP. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in*, 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5874.

63. The rule articulated by the Fourth Circuit is a modified net result rule. Like the net result rule, a creditor may carry forward preferential payments until exhausted against subsequent advances. Unlike the net result rule, a creditor may not use a prior advance to offset a subsequent preferential payment.

64. Gold Coast Seed Co. v. Spokane Seed Co. (*In re* Gold Coast Seed Co.), 30 Bankr. 551, 553 (Bankr. 9th Cir. 1983).

65. Eisenberg v. O. Censor & Co. (*In re* Baumgold Bros., Inc.), 103 Bankr. 436, 440 (Bankr. S.D.N.Y. 1989). An example illustrates the absurd results the *Leathers* approach

to apply the net result rule, one creditor may prejudice other unsecured creditors by colluding with the debtor when bankruptcy is imminent.[66] If a creditor has an unused balance of new value, "[t]he net-result rule allows the debtor to make a payment to the creditor in an amount equal to the unused balance of new value, thereby preventing the trustee from recovering that amount."[67] This result reduces the funds available for distribution to the unsecured creditors.[68] In contrast, the Fourth Circuit's approach prevents this abuse by requiring the debtor's payment to precede the new value.

Moreover, the Fourth Circuit's approach is consistent with the plain meaning of section 547(c)(4).[69] An interpretation that would not allow a creditor to carry forward preferential payments and set them off against subsequent advances "places limitations on the creditor's right of set off not found in the statutory language."[70]

The Fourth Circuit's interpretation of section 547(c)(4) represents a compromise, supported by the plain meaning of the statutory language, that best encourages creditors to assist financially troubled debtors without prejudicing other unsecured creditors. Moreover, the practical significance of the Fourth Circuit's holding is two-fold: Under section 547(c)(4) creditors may not rely on an extension of credit prior to a preferential payment to circumvent the trustee's avoidance powers, and creditors may carry forward, until exhausted, preferential payments made by debtors.

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could produce. Suppose that the creditor satisfied all other requirements of section 547(c)(4). Ten days prior to the filing of bankruptcy, the debtor made a preferential payment to the creditor of $200,000; nine days prior, the creditor advanced the debtor $10,000; eight days prior, the debtor made another preferential payment of $10,000; and seven days prior, the creditor advanced $200,000. Under the *Leathers* rule, the trustee could avoid $190,000. Under the Fourth Circuit's view, the creditor would carry forward the excess $190,000 in preferential payments after the first subsequent advance. The creditor would net the second subsequent advance against the $190,000 carry forward plus the additional payment of $10,000, and the trustee could not avoid either payment. The *Leathers* rule would encourage the creditor to make a second advance of only $10,000.

66. Comment, *supra* note 38, at 973.

67. *Id.*

68. *Id.*

69. *Id.* at 972.

70. Thomas W. Garland, Inc. v. Union Elec. Co. (*In re* Thomas W. Garland, Inc.), 19 Bankr. 920, 926 (Bankr. E.D. Mo. 1982).