Selected Issues and Developments in Consumer Bankruptcy, and the Impact of the 2005 Bankruptcy Code Amendments

Alvin C. Harrell, Oklahoma City University School of Law
Jeffrey E. Tate
Gary D. Hammond

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By Gary D. Hammond, Jeffrey E. Tate, and Alvin C. Harrell

I. Bankruptcy Filing Rates

While bankruptcy filing rates dipped slightly during the twelve-month period ending June 30, 2004, and again in the twelve-month period ending March 31, 2005, the twelve-month period ending June 30, 2003 marked new records both in the number of total bankruptcies filed and in the number of non-business bankruptcy cases filed. In the one-year period ending June 30, 2003 there were 1,695,270 bankruptcy filings, the largest number of cases ever filed until then in any twelve-month period. This constituted a 9.6 percent increase in filings over the twelve-month period ending June 30, 2002. While both consumer and business filings dipped slightly in the twelve-month period ending March 31, 2005, the number of consumer cases filed in the one-year period ending March 31, 2004 was a new high for that reporting period (1,654,847). Thus the upward trend was clear prior to the 2005 Bankruptcy Code amendments. It will be interesting to note the impact, if any, of those changes.

Consumer bankruptcies have persistently posted historic numbers since enactment of the Bankruptcy Reform Act of 1978, despite periodic modest declines as in early 2005. As noted above, in the twelve-month period ending March 31, 2004 personal bankruptcies reached a new high. Consumer bankruptcy filings in the same three period totaled 1,613,097, itself an increase of ten percent from the twelve-month period ending June 30, 2002. Business filings, on the other hand, fell 5.2 percent, to 37,182. The breakdown of filings by Bankruptcy Code Chapter for the twelve-month period ending June 30, 2003 continued in 2004 is illustrative of this trend, as follows:

<table>
<thead>
<tr>
<th>Chapter</th>
<th>2002</th>
<th>2003</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,053,230</td>
<td>1,165,993</td>
<td>+10.7%</td>
</tr>
<tr>
<td>3</td>
<td>440,231</td>
<td>472,811</td>
<td>+7.4%</td>
</tr>
<tr>
<td>11</td>
<td>367</td>
<td>775</td>
<td>+111.2%</td>
</tr>
<tr>
<td>12</td>
<td>11,401</td>
<td>10,602</td>
<td>-7%</td>
</tr>
</tbody>
</table>

II. Statutory Changes to Bankruptcy Rules

Since 2002, federal procedural rules have undergone significant changes that affect bankruptcy, and though even more changes are in process to respond to the 2005 amendments, these earlier rule changes remain important. As its exceptions within the language of the fee item to alleviate confusion.

- Case Reopening: Under the 2003 changes, language was
- Amendment: Each amendment to the debtor's list of creditors, matrix, or mailing lists, with two exceptions, requires a $250 fee. Under the exceptions, no fee is charged: (1) to change the address of a listed creditor; or (2) to add the name and address of a listed creditor's attorney. The Judicial Conference approved an amendment to this fee that would set forth the two

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Gary D. Hammond is a shareholder of Hammond, Rea, and Eierman, P.C.L.C., in Oklahoma City. He focuses his practice on bankruptcy and commercial litigation. Mr. Hammond is the author of numerous articles and a frequent speaker on bankruptcy and commercial litigation topics. Mr. Hammond is a graduate of the University of Oklahoma and a graduate of the University of Oklahoma College of Law. Mr. Tate received his B.A. degree from Oklahoma University and his J.D. degree from the University of Oklahoma College of Law. Mr. Tate is a member of the bankruptcy section of the Oklahoma Bar Association and the Oklahoma County Bar Association. Mr. Harrell is a member of the American Bankruptcy Institute, the Commercial Law League of America, and the National Association of Consumer Bankruptcy Attorneys.

Jeffrey E. Tate is an associate with the law firm of Edwards, P содержит и телефона на русском языке, а также на английском языке. Часто упоминаются имена и фамилии различных людей, а также различные даты и числа, соответствующие событиям в различные периоды времени.
The Advisory Committee also approved for publication and comment proposed amendments to Bankruptcy Rules 1096, 2002, 9001, 4002, 7004, and Bankruptcy Form 6. The following is a summary of these amendments:

- Rule 3004 is confirmed to section 501(c) of the Bankruptcy Code. The 2004 amendment does not allow the debtor or the trustee to file a proof of claim until after the time for filing a proof by a particular creditor has expired.
- Rule 3005 is confirmed to section 501(b) of the Bankruptcy Code. This amendment deleted any reference to a creditor filing a proof of claim that supersedes a claim filed on behalf of the creditor by a codebtor.
- Rule 4098 was amended to require that reaffirmation agreements be filed within thirty days after the entry of an order granting a discharge.
- Rule 7004 was amended to authorize the clerk specifically to sign, seal, and issue a summons electronically. The amendment does not address the service requirements for summonses that are set out in other provisions of Rule 7004.

In January 2004, at the Committee on Rules of Practice and Procedure meeting, the Advisory Committee proposed amendments to Bankruptcy Rules 5005(c) and 9036. Rule 5005(c) was amended to include the clerk of the bankruptcy appellate panel and district judges among the list of persons required to transmit erroneously delivered or transmitted papers. Rule 9036 deleted the requirement that the sender of an electronic notice must obtain an electronic confirmation that the notice was received. The Advisory Committee approved these amendments and published the amendments for public comment.
A. Surrender of Collateral After Chapter 13 Confirmation

By now, the battle between debtors and secured creditors concerning the ability of the debtor to modify a Chapter 13 Plan and to surrender collateral in connection with the satisfaction of debt is well known to most bankruptcy practitioners. Courts have been split as to whether the Bankruptcy Code permits this or not, but the issue may have been resolved by the 2005 Bankruptcy Code amendments. Particularly, instead of bankruptcy commentators have disagreed as to whether this type of modification was permitted under the Bankruptcy Code. Two bankruptcy trustees suggested that a Chapter 13 plan could be modified to surrender collateral and reclassify the resulting deficiency if the other requirements for confirmation of a modified plan were satisfied. However, another noted trustee concluded that "the emerging majority position is that section 1329 may not be utilized by a debtor to voluntarily surrender collateral and reclassify any deficiency after the creditor's sale of the collateral and associated cure requirements." The two positions are typified by the cases of In re Hernandez23 and In re Wilco.24 In Hernandez, the debtors owned a 2000 Chevrolet S-10 pickup truck, which was collateral for a loan from Household Auto Finance (Household).25 The debtors originally confirmed a Chapter 13 Plan providing Household a $13,322.42 secured claim, and proposing to pay the remainder of its debt pro rata with other unsecured claims.26 Subsequently, the debtors fell behind in their mortgage payments and filed a motion to modify their Chapter 13 Plan.27 The debtors made a motion to modify their Chapter 13 Plan a second time in order to cure mortgage arrearages.28 This second motion to modify also proposed to surrender Household's vehicle collateral in full satisfaction of its secured debt.29 Household objected, arguing that the debtors' proposed modification was prohibited as a matter of law.30

In Hernandez, the bankruptcy court rejected Household's argument and confirmed the modified plan while in rem. As to the reasoning espoused in Keith Lunn's treatise The Bankruptcy Code, the Hernandez court concluded that no express statutory prohibition against such a modification existed.31 Further, the Hernandez court reasoned that Bankruptcy Code section 502(j), allowing for reconsideration of secured claims, and section 506(a), allowing for determination of secured claims in conjunction with "any hearing...on a plan affecting such creditor's interest," jointly contemplate that determination of a secured claim can be had in conjunction with Chapter 13 Plan modification hearings. In Wilco, another bankruptcy court confronted the issue of whether a debtor could modify a confirmed Chapter 13 Plan to provide that certain collateral would be surrendered in full satisfaction of that creditor's claim as valued in the confirmed Plan.32 The debtor in Wilco filed her Chapter 13 Petition and Plan on May 21, 2001, and confirmed her Chapter 13 Plan on August 27, 2001.33 Under her Chapter 13 Plan the debtor retained a vehicle, which Arcadia Financial, Ltd. had financed pursuant to a purchase-money security interest.34 As an accommodation to the debtor, Arcadia agreed to a cramdown of its claim in the Chapter 13 Plan.35 Additionally, the debtor's Chapter 13 Plan allowed the debtor to make her loan mortgage payments outside her Chapter 13 Plan. However, the debtor eventually fell behind in her mortgage payments. On February 27, 2002, the debtor obtained a modification of her Chapter 13 Plan, allowing mortgage payments to be made outside the Chapter 13 Plan and allowing the debtor to cure her mortgage arrearages.36 In September 2002, the debtor again sought to modify her Chapter 13 Plan, this time to surrender her automobile in full satisfaction of Arcadia's claim.37 The debtor argued that Bankruptcy Code section 1325(f)(5)(C) was applicable to Chapter 13 Plan modifications by virtue of Bankruptcy Code section 523(b). Arcadia countered by arguing that the proposed surrender modification would result in a second cramdown of its claim. Moreover, Arcadia posited that section 1323(a) permits only modification of the amount and timing of payments, and does not authorize modification of the total amount of claim.38 Though the Wilco court found the debtor's arguments logically appealing, it concluded that Arcadia's position was more legally convincing.39 The court held that the plain language of section 1329 does not permit modification of a Chapter 13 Plan to effect surrender of collateral and concomitant satisfaction of the claim.40

In re Taylor41 presents a slight twist on these scenarios. In Taylor, after the bankruptcy court had approved a Chapter 13 Plan allowing the debtor to keep his car, the creditor voluntarily returned the car to the creditor.42 The creditor took possession of the car and sold it before the hearing on modification.43 The court concluded that because there was no longer any collateral there could be no secured claim.44 The full impact of the 2005 Bankruptcy Code amendments will have to await judicial interpretation, but an initial analysis indicates a resolution of this problem. Bankruptcy code section 502(j) was not amended; section 506 was amended by the addition of section 506(a)(2), but this is directed at valuation of the collateral45 rather than modification of the Plan.46 Section 1325(a)(5) (Plan Confirmation) was amended to, among other things, protect certain purchase-money security interests from cramdown and require that the bankruptcy petition be filed in good faith. These changes will protect secured parties in other ways but also directly govern plan modification, if incorporated into section 1329 by section 1329(b) (as argued unsuccessfully by the debtor in Wilco). Certainly the 2005 amendments to section 1325(a)(5) make the debtor's argument in Wilco less appealing, and the impact of the Hernandez ruling (that there is no statutory bar to modification) seems to be undercut by the new language.

B. Conversion from Chapter 7 to Chapter 13

1. Legal Context

Do the Bankruptcy Code and Bankruptcy Rules provide Chapter 7 debtors with an alternative, one-time right to convert to Chapter 13? This has been an issue of some contention. A debtor's ability to convert a case from Chapter 7 to Chapter 13 is governed by section 706 of the Bankruptcy Code, which provides as follows:

(a) The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1123, 1208, or 1307 of this title. No waiver of the right to convert a case under this subsection is unenforceable.

(b) On request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time.

(c) The court may convert a case under this chapter to a case under chapter 12 or 13 of this title unless the debtor requests or consents to such conversion.

(d) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

Conversion is also affected by Bankruptcy Rule 1017, which states in part:

(a) Voluntary dismissal; dismissal for want of prosecution or other cause: Except as provided in sections 707(a)(3), 707(b), 1231(b), and 1307(b) of the Bankruptcy Code, and in Rules 1017(b), (c), and (e), a case shall not be dismissed on motion of the debtor or the United States trustee for want of prosecution or other cause, or by consent of the parties, before a hearing on notice as provided in Rule 1007. For the purpose of the notice, the debtor shall file a list of creditors with their addresses within the time fixed by the court unless the list was previously filed. If the debtor fails to file the list, the court may order the debtor or another entity to prepare and file it.

2. Procedure for dismissal, conversion, or suspension:

(1) Rule 9014 governs a proposed motion to dismiss or suspend a case, or to convert a case to another chapter, except under sections 706(a), 112(a), 1208(a) or (b), or 1307(a) or (b).

(2) Conversion or dismissal under sections 706(a), 112(a), 1208(a) or (b), or 1307(a) or (b) is by motion filed and served as required by Rule 9013.

(3) A chapter 12 or chapter 13 case shall be converted without court order when the debtor files a notice of conversion under sections 1205(a) or 1307(a). The filing date of notice...
becomes the date of the conversion order for the purposes of applying [section 348(e)] and Rule 1019. The clerk shall promptly transmit [the order] to the United States trustee.

The courts have been split on whether a debtor possesses a one-time absolute right to convert a Chapter 7 case to one under Chapter 13. The split is caused by differing interpretations of the phrase "at any time," together with the statute's legislative history that requires that result.

In In re Widdicomb, 56 the issue was whether the debtor had an absolute right to convert a Chapter 7 case to a Chapter 13 case pursuant to section 706(a). The Widdicomb court noted that section 706(a) requires consideration of whether a debtor seeking to convert from a Chapter 7 to a Chapter 13 meets the basic requirements of "who may be a debtor," in a Chapter 13 case under Bankruptcy Code section 109(a). The Widdicomb court held that the plain language of section 706(a) does not provide a debtor with an absolute right to convert a Chapter 7 case. These courts conclude that the phrase "at any time" refers to the point in time within the bankruptcy process in which conversion may occur, rather than creating an unqualified right to multiple conversions.

In In re Starkey, 57 for example, the scope of a debtor's right to convert was thoroughly examined. The Starkey court concluded that the "language of section 706, read as a whole, indicates that the [debtors] do not have any 'absolute right' to convert regardless of circumstances." 58 In Starkey, the debtor moved to convert his Chapter 7 case to Chapter 12 after the bankruptcy court granted the trustee's motion to reject certain contracts. The debtor claimed that he had an absolute right to convert his case to Chapter 12 because of the phrase in section 706(a) "at any time." The debtor also argued that the legislative history of section 706 evinced Congress's intent to afford a one-time absolute right to conversion.

In a thorough opinion, the Starkey court rejected both of the debtor's arguments. The bankruptcy court reasoned that section 706(a)'s language "at any time" means merely that conversion can be sought at any stage of litigation, not that conversion is mandatory at the debtor's discretion despite the debtor's abuses or undue prejudice to creditors. 59 The Starkey court also reasoned that nothing in section 706 eliminates a court's "fundamental power and duty" to prevent abuse. Finally, after a detailed analysis concerning the legislative history of section 706, the Starkey court concluded:

The legislative history indicates that Congress actually intended conversion at an officer's option under section 706(a) or to be granted more readily than at creditors' request under section 706(b); but indicates also that Congress never meant the term "at any time" to prevent the court from exercising some discretion, taking into account the interests of all concerned in order to guard against abuse. 60

Moreover, most courts reason that an absolute right to convert cannot exist because such a right would render meaningless Bankruptcy Rules 1019(f), 1019, and 2002(a), which permit conversion only after filing a motion, notifying creditors, and holding a hearing on the issue. 61

Perhaps because this issue seems increasingly well-settled, the 2005 Bankruptcy Code amendments make no relevant revision to section 706. 62 But that is a different issue from whether conversion is appropriate, as noted below.

4. Whether Conversion Is Appropriate

The courts following the Starkey line of reasoning, such as In re Young, 63 typically have articulated a separate issue as to whether conversion is appropriate and have considered various facts that should be considered in determining whether to deny a motion to convert under section 706(a). These factors include:

• whether conversion is being sought in good faith;
• whether the debtor can propose a confirmable Chapter 13 Plan;
• the impact on the debtor of denying conversion weighed against the prejudice to creditors caused by allowing conversion;
• the effect of conversion on the efficient administration of the bankruptcy estate, including the likelihood of a recovery to a Chapter 7 creditor; and
• whether conversion would further abate the bankruptcy process and would serve to protect, rather than implement, Congressional policy. 64

In In re Gilley, 65 the First Circuit Bankruptcy Appellate Panel (BAP) affirmed the bankruptcy court's denial of the debtors' motion to convert their Chapter 7 case to Chapter 13. The debtor's schedules disclosed that after expenses it had surplus income of only $182.82 per month. The debtors filed a motion to convert to Chapter 13 and submitted a Plan that proposed to pay only secured debts and administrative expenses. 66 The BAP reasoned that because the debtors' income was inadequate to support a feasible plan, conversion would be an extreme in futility, and that the bankruptcy court's denial of the debtors' motion to convert was appropriate. 67

C. Counsel Compensation from Estate Property

Ever since the Fifth Circuit's decision in In re Ecrope, 68 the court has held that a court may not award counsel compensation from estate property.

The court reasoned that even though the estate was small, the court should not allow the attorney to be paid from the estate property. The court noted that even if the attorney had been a requested by a creditor, it would not be proper to allow counsel compensation from estate property.

This argument was made on the Fifth Circuit's decision in In re Ecrope, and is in progeny. The court has held that even though the estate was small, the court should not award counsel compensation from estate property.

405.
The omission of this "or" was cited in Top Grade as evidence that section 330 was grammatically sound and therefore ambiguous.294 Arguably this revision undercuts the rationale of Top Grade as well as other cases concluding that omission of the debtor’s attorney from section 330 was inadvertent.

D. Discharge of Student Loan Debt

In In re Saxman,295 the Ninth Circuit Court of Appeals rejected the "all or nothing" approach to discharge of student loans, holding that courts may partially discharge student loan debt under the general equitable authority of Bankruptcy Code section 105(a).296 In coming to the conclusion that student loan debt is partially dischargeable, the court held that the words "such debt" in Bankruptcy Code section 523(a)(8) are not intended to limit the court’s basic powers to fashion remedies to carry out the provisions of the Bankruptcy Code.297

Fur\ermore, the Saxman court adopted the Brunner test.298 In Brunner v. New York State Higher Educ. Services,299 the Second Circuit Court of Appeals articulated a test to determine whether failing to discharge student loan debt from discharge would impose an undue hardship on the debtor.300 Under the Brunner test, a debtor must prove that:

- he or she cannot maintain, based on current income and expenses, a "minimal" standard of living for himself and his dependents if forced to repay the loans;
- additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loan; and
- the debtor has made good faith efforts to repay the loans.301

To date, the Second, Third, Fourth, Seventh, Ninth, and Eleventh Circuit Courts of Appeals have adopted the Brunner test.302 In In re Cox,303 for example, the Eleventh Circuit Court of Appeals adopted the Brunner test as the standard for determining "undue burden" under Bankruptcy Code section 523(a)(8) and, addressing an issue of apparent first impression for the Eleventh Circuit, held that a partial discharge of student loan debt is not possible without a finding of "undue hardship."304

However, in In re Long,305 the Eighth Circuit Court of Appeals expressly rejected the Brunner test.306 In Long v. Woodcock,307 the Eighth Circuit concluded that the Brunner test was inapplicable because it was a single circuit precedent, not a controlling precedent. Instead, the Eighth Circuit relied on the Brunner test to determine whether student loans were dischargeable under the undue hardship exception.308

In Woodcock the Eighth Circuit chose not to utilize the Brunner test but instead opted to employ the Craig methodology, the French good faith and policy tests, and the Brunner objective test.309 The Eighth Circuit could have used this case as an opportunity to adopt the Brunner test but instead simply affirmed the bankruptcy court’s conclusion under the undue hardship exception for the reasons stated by the bankruptcy court.

Section 523(a)(8) was completely rewritten as part of the 2005 Bankruptcy Code amendments, apparently in response to this case law and the controversy over the Brunner test. Revised section 523(a)(8) now states:

(u) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents, for—

(A) (i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or part by a governmental or nonprofit institution;

(ii) an obligation to repay funds received as an educational benefit scholarship, or stipend; or

(B) any other educational loan that is a qualified education loan, as defined in section 221(d)(5) of the Internal Revenue code of 1986 by a qualified individual...
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fee, is sufficient for due process. [189] Under the Arlotz court's reasoning, either procedure gives debtors an opportunity to object and be heard. [190]

2. In re Suber International, Inc. [191]

In Suber, prior to the debtor's bankruptcy filing, the lending bank placed Suber into a state court receivership. [192] The bank's loan was secured in part by a stock pledge agreement. [193] In the receivership case, the state court ordered the appointed receiver to operate Suber in its ordinary course of business. [194] The state court also authorized the receiver to hire professional advisors as needed. [195] Subsequently, the receiver hired the accounting firm of which he was part owner, as accountants for Suber. [196] During the state court proceeding, the receiver and his accounting firm incurred fees and expenses in the performance of their duties totaling approximately $44,000. [197] The receiver argued that both the receiver and his accounting firm, all of the amounts paid to them, including the amounts owed to the receiver individually, would be paid directly to the accounting firm for distribution to members of the firm under the general terms governing their professional corporation. [198]

Eventually, the bank exercised its power under the stock pledge agreement, appointed the receiver as Suber's Chief Executive Officer (CEO), and directed the receiver to place the corporation in Chapter 11 bankruptcy. [199] On the day the receiver filed the bankruptcy petition, he also caused the company to transfer $46,000 to his accounting firm's trust account. [200] This action was done without state court approval. [201] These funds, which ultimately would be paid to the receiver's accounting firm, were to be held for eventual payment of the receiver fees upon bankruptcy court approval. [202]

After the bankruptcy filing, the receiver sought bankruptcy court authority to hire his accounting firm as accountants for the debtor corporation. [203] In support of the request, the receiver filed an affidavit asserting that he and his accounting firm were "disinterested" persons under Bankruptcy Code section 101(14), and that neither party had an interest adverse to the debtor. [204] The affidavit further failed to disclose that the accounting firm was holding the $46,000 that Suber had paid prepetition into the accounting firm's trust account. [205] Upon the receiver's motion to recover prepetition compensation owed during the state court receivership, the bankruptcy court reviewed the prepetition association between the receiver and the accounting firm, as well as the transfer of the $46,000. [206] Ultimately, the bankruptcy court found that the accounting firm was not disinterested. [207] Further, the court noted that the failure to advise the court of the fact that the receiver was a prepetition creditor of the debtor or that the accounting firm held a direct pecuniary interest in the receiver's claim was improper under the disclosure requirements of Bankruptcy Rule 2014(a). [208] The court held that the accounting firm's failure to make such disclosures constituted cause to deny the firm any post-petition compensation. [209]

3. De Leon v. Comar Industries, Inc. [210]

In De Leon, the debtor filed an Equal Employment Opportunity Commission (EEOC) charge on December 2, 1999. [211] On November 7, 2000, the debtor filed a Chapter 13 bankruptcy. [212] On April 19, 2001, the debtor received a "right to sue" letter from the EEOC, and on May 14, 2001, the debtor sued his former employer for discrimination and retaliation. [213] The debtor neither listed these causes of action under his original bankruptcy pleadings, nor did he amend the pleadings to disclose the lawsuit filed on May 14, 2001. [214]

Concord, the former employer, sought to dismiss the debtor's discrimination lawsuit under the theory of judicial estoppel. [215] As argued by Concord, the debtor should be estopped from pursuing the claim because he did not disclose his actions in his bankruptcy recognition petition, or at any time before or after the bankruptcy court ruled on the debtor's claims and a motive to conceal them from the court. [216] The Eleventh Circuit U.S. Court of Appeals agreed with Concord and dismissed the debtor's lawsuit under the doctrine of judicial estoppel because sufficient evidence showed that the debtor's omission of the claim from his bankruptcy schedules was intentional. [217] To hold otherwise, the Eleventh Circuit relied on its prior decision in Varnes v. Fennco Apecos Inc. [218] where it came to the same conclusion in the context of a Chapter 7 proceeding. [219]

4. In re Hedged-Investments Assoc., Inc. [220]

In Hedged-Investments, an undersecured creditor moved for allowance of post-petition attorneys' fees in the amount of $504,308.34 based on its loan agreements with the debtor. [221] The loan agreements expressly provided for recovery of attorneys' fees and costs. [222] The Hedged-Investments court noted that some courts permit unsecured creditors to recover attorney's fees and costs if permitted pursuant to the parties' contractual obligations. [223] However, the court held that Bankruptcy Code section 506(b) abrogates a state law contract recovery in bankruptcy. [224] According to the Hedged-Investments court, section 506(b) entitles only over-secured creditors to recover fees and costs. [225] Further, the court held that the fact Congress did not provide for the recovery of post-petition fees and costs by unsecured and under-secured creditors demonstrates Congressional intent to disallow such recovery by creditors whose claims are not over-secured. [226] The 2005 Bankruptcy Code amendments do not include any revisions with an apparent impact on this issue.

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