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College's Failure to Provide Educational Service Is No Defense to Nonpayment of Student Loans

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Recent Cases

College's Failure To Provide Educational Service Is No Defense To Nonpayment Of Student Loans

In *Veal v. First American Savings Bank,* 914 F.2d 909 (7th Cir. 1990), the United States Court of Appeals for the Seventh Circuit held that despite a close connection between a college and two lenders of student loans, the college's alleged fraudulent activity and failure to provide educational service was no defense to loan repayment unless the loans were guaranteed by the federal government. The court affirmed the district court's dismissal of the fraud complaint because the claim did not specify particular acts of fraud, as required by Rule 9(b) of the Federal Rules of Civil Procedure. Fed. R. Civ. P. 9(b). In addition, the court noted that the Federal Trade Commission rule regarding the preservation of consumer defenses, 16 C.F.R. § 433.2 (1991), is inapplicable to loans made, issued, or guaranteed under the Higher Education Act of 1965. 20 U.S.C.A. §§ 1070-99 (West 1991).

Background

Representatives of Adelphi Business College ("Adelphi") recruited Kerry Veal and several of his classmates ("the Students"). The only qualifications required of the Students were that they have a legitimate permanent address and phone number and that they be unemployed. An Adelphi recruiter approached each student, either on the street or by telephone, and described Adelphi's ability to help them find a job. Arriving at Adelphi, the Students took a ten minute "entrance examination" and enrolled in a "bookkeeping" course. Adelphi told the Students that they should not worry about financing their Adelphi education because the school had made loan arrangements for them.

Adelphi prearranged loans for the Students with First American Savings Bank and with Security Savings and Loan Association ("the Lenders"). Adelphi used the Lenders' loan forms and promissory notes preprinted with the respective Lender's name which the Lenders had already approved. The Students signed the promissory notes at the time of enrollment. Adelphi assured the Students that the school had prearranged loan approval with the Lenders and made certain that the requisite loan forms reached the Lenders. The Lenders continually made the loans to finance the education promised by Adelphi.

After beginning the "bookkeeping" course, one of the Students attempted to enroll in a computer course, only to learn that Adelphi had no computers. Another of the Students entitled to a refund on his student loan never received the refund. Other students never received diplomas, certificates, or job placement assistance. Adelphi eventually filed for bankruptcy and closed, making it impossible for the Students to complete their courses. The Lenders informed the Students that since the Students were no longer enrolled in school, they were expected to begin repaying their loans immediately. The Students filed a claim in the United States District Court for the Northern District of Indiana against the Lenders and others, seeking rescission of their guaranteed student loans, reinstatement of their Pell Grant eligibility, and damages. The Students did not name Adelphi as a defendant in this case. Instead, the Students declared that the existence of a "close connection" between Adelphi and the Lenders rendered the Lenders liable for Adelphi's alleged wrongdoing.

The District Court's Decision

The district court granted the Lenders' motion to dismiss the Students' complaint. The Students' complaint centered around the alleged fraudulent activity of Adelphi. The Students claimed that Adelphi breached its promise to provide the Students with an education and job placement services, that it used material misstatements to induce the Students to enroll in the school, and that Adelphi breached its duty of care by negligently failing to use reasonable means to give the Students truthful and accurate information. The Students also alleged that Adelphi and the Lenders violated the Higher Education Act of 1965 ("HEA"), 20 U.S.C.A §§ 1070-99 (West 1991) and that Adelphi breached its fiduciary duty to the Students. Finally, the Students stated that Adelphi and the Lenders violated the Indiana Deceptive Practices Act. Ind. Code Ann. §§ 24-5-0-5-1-5-9 (West 1980 & Supp. 1990).

In response to the Students' counts, the Lenders filed a motion to dismiss for failure to state a claim. The Lenders maintained that the case was subject to the HEA which preempts the Students' state law remedies; the HEA did not provide for a private right of action. Furthermore, the Lenders claimed that the Students did not specifically charge the Lenders with any wrongful activities. The trial court rejected the Students' "close connection" argument; the trial court granted the Lenders' motion to dismiss for failure to state a claim. The Students appealed the dismissal to the United States Court of Appeals for the Seventh Circuit.

The Seventh Circuit's Opinion

In affirming the lower court's dismissal of the action, the Seventh Circuit addressed the Students' claims based on fraudulent activity, their suggestion of a "close connection" between Adelphi and the Lenders, and their attempt to apply the Federal Trade Commission ("FTC") rule on the preservation of consumer defenses, 16 C.F.R. § 433.2 (1991), and the Indiana Code, Ind. Code Ann. §§

26-1-3-306 (West 1980 & Supp. 1990), to the Lenders.

The court observed that the Students' claims were based on Adelphi's alleged fraudulent activities. Some claims referred to specific instances of fraud while others pointed to a breach of fiduciary duty and negligence contingent on Adelphi's alleged fraudulent activities. In addition, other purported facts, if proven, would have suggested fraud on the part of Adelphi. According to Rule 9(b) of the Federal Rules of Civil Procedure, Fed. R. Civ. P. 9(b), a plaintiff's claim of fraud must include particular statements and actions alleged to be fraudulent as well as the reasons why the statements or actions are fraudulent. In this case, the Students did not charge the Lenders with any specific wrongful actions. Hence, the court found that the Students failed to meet the particularity standard required by Rule 9(b).

Although the Students did not charge the Lenders with any wrongful conduct, the Students proposed that the claims against Adelphi should be attributed to the Lenders because of the "close connection" between the two. Adelphi had chosen the Lenders, used their preprinted forms, and represented the Students in all dealings with the Lenders. The Students suggested that this connection constituted an "origination relationship." Such a relationship exists when a lender allows a school to execute many of the lender's responsibilities associated with the making of loans, such as completing loan forms normally completed by the lender. 34 C.F.R. § 682.200 (1989). The Students argued that an origination relationship may serve as a defense to the nonpayment of loans if a school does not render educational services. The Students claimed that the "origination relationship" between Adelphi and the Lenders precluded repayment of the loans to the Lenders since Adelphi failed to provide the Students with an education.

However, for these defenses to apply, the court of appeals noted that the loans must have been Federal Insured Student Loans, Federal PLUS loans, or other loans guaranteed by the federal government. The loans in the present case were not federally guaranteed. Rather, they were guaranteed by the Lenders which were state and private institutions. Thus, the Students' "origination relationship" argument could not stand.

The Students then attempted to hold the Lenders liable for charges against Adelphi under the FTC rule on the preservation of consumer defenses. The FTC rule states that consumer credit contracts must contain a stipulation informing holders of such contracts that they are subject to all of the debtor's claims and defenses against the seller of goods and services. 16 C.F.R. § 433.2 (1991). However, loans made, issued or guaranteed under the HEA, as the loans were in this case, were exempt from the FTC rule. Thus, the FTC rule did not apply to the Students' claims.

Finally, the students argued that they were eligible to recover under the Indiana Code provision referring to liabilities of assignees and assignors. Ind. Code. Ann. §§ 26-1-3-306 (West 1980 & Supp. 1990). Under the Code, an assignee of an instrument who is not a holder in due course is subject to defenses raised against the assignor. However, the court found that the Indiana Code was irrelevant in this case since the Lenders were never assignees of Adelphi but instead were the original holders of the notes.

Because the Students failed to show that the Lenders were liable for Adelphi's actions, the court affirmed the district court's dismissal for failure to state a claim. The court noted, however, that the students had not exhausted their remedies. The Department of Education had issued student loan write-off procedures following the decision of the district court. In addition, the students could file bankruptcy claims and assert state defenses if sued in state court for collection of the student loans.

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Third-Party Contractual Risks Not Covered By Builder's Risk Insurance Policy

In *Trinity Industries, Inc. v. Insurance Company of North America*, 916 F.2d 267 (5th Cir. 1990), the United States Court of Appeals for the Fifth Circuit held that a builder's risk insurance policy did not cover arbitration costs awarded against the policyholder to correct faulty workmanship. The court also found that the policy did not cover contractual risks agreed upon by a policyholder and a third party.

Background

In December, 1980, Halter Marine, Inc. ("Halter"), which Trinity Industries, Inc. ("Trinity") acquired prior to judgment, agreed to build six supply boats for Leam Transportation, Inc. ("Leam"). The contract included a warranty for workmanship and provided for arbitration in the event of any dispute between the parties. The contract also required that Halter carry hull, P & I, and builder's risk insurance. The Insurance Company of North America ("INA") provided insurance under a policy that listed Halter and Leam as co-insureds and co-loss payees.

In one of the vessels built, the M/V LEAM ALABAMA, Halter misaligned two of the modular hull sections, creating a "twist" in the vessel. This twist caused one corner of the vessel to be seven to twelve inches lower than the other.

Upon receipt of the M/V LEAM ALABAMA in February 1982, Leam became aware of the twist when it had problems trimming the vessel. In accordance with the terms of the contract, Leam made a written complaint and returned the vessel to Halter for repairs. Claiming that the twist was within shipbuilding standards, Halter refused to repair the vessel. In July 1983, Leam filed for arbitration, seeking $2.3 million in damages and return of its purchase price. Leam argued that the twist in the hull made the vessel useless.

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