PICK YOUR POISON: SUPREME COURT FINDS BANK LIABLE FOR THIRD PARTY EMPLOYEE'S FRAUD

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The Supreme Court of Canada has clarified the limits of a major defence available to banks who face liability for processing fraudulent cheques. In *Teva Canada Ltd. v TD Canada Trust*[1], the Supreme Court held that banks who accept fraudulent cheques are required to repay the innocent drawer unless the bank can prove (a) that the company did not actually intend for the payee to receive the cheque, or (b) that the payee was neither a legitimate creditor of the company nor an entity that the company could have reasonably mistaken for a legitimate creditor.

In Teva, the Supreme Court was tasked with deciding which innocent party, the company or the bank, should bear the losses resulting from the misconduct of the company's employee. The employee had fraudulently requisitioned cheques payable to entities with similar or identical names of the company's real creditors. As a result of the employee's scheme, the company issued the requisitioned cheques and mechanically applied the appropriate signatures. The employee opened several bank accounts under the names of the payees of the fraudulent cheques. Over the course of three years, the employee deposited 63 fraudulent cheques totalling $5,483,249.40. These funds were later transferred to the employee's personal accounts[2].

Section 20(5) of the Bills of Exchange Act

The only issue to be decided in Teva was the applicability of section 20(5) of the *Bills of Exchange* Act[3], which provides banks with a defence to claims for conversion.

In general, a bank is liable for the tort of conversion when it negotiates a cheque and makes the proceeds available to someone other than the person rightfully entitled to payment. Conversion is a strict liability tort, meaning that the bank will be liable even if it was diligent and acted in good faith, and regardless of any negligence or carelessness of the drawer company.

Section 20(5) provides that a bank can validly negotiate a cheque (and avoid liability for conversion) when the cheque is made out to a payee who is "fictitious or non-existent", which is often the case in situations involving fraud. In theory, section 20(5) aims to protect banks from fraud committed by a third party against the drawer, including an insider in the drawer organization. The section allocates the loss to the

[1] 2017 SCC 51 ["**Teva**"]
[2] It is unclear whether the bank was able to recover any funds from the rogue employee.
[3] RSC 1985, c B-4.

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drawer, who is typically better positioned to detect and discover the fraud internally[4]. Through the use of internal accounting processes and authorization policies, companies should be able to prevent the issuance of cheques to entities it is not indebted to or does not intend to pay.

The Supreme Court's Decision

At the Ontario Court of Appeal, the Court held that section 20(5) afforded the bank with a valid defence. Accordingly, the company had to bear the cost of its employee's fraud. Writing for a unanimous court, Justice Laskin reasoned that the payees were fictitious because the company was unable to prove that it intended the payees to receive the proceeds of the cheques[5].

The Supreme Court overturned the Court of Appeal's decision. Writing for a 5-4 majority, Justice Abella rendered a decision that prioritizes consistency of judicial interpretations within the bills of exchange context. Relying on the Supreme Court's prior decisions in *Boma Manufacturing Ltd. v CIBC*[6] and *Royal Bank of Canada v Concrete Column Clamps (1961) Ltd.*,[7] Justice Abella reiterated, in clear terms, the analysis required to determine whether a payee can be considered fictitious or non-existent under section 20(5).

For a payee to be fictitious, the drawer must lack a subjective intention to pay the payee. In these situations, the cheque is not intended to reflect the payment of a genuine pre-existing debt. Rather, the payee's name is inserted "by way of pretence only".[8] The drawer as a whole (and not just its rogue representative), must be subjectively aware that the cheque is being made out to a payee who the drawer does not intend to pay. Justice Abella concluded that in the absence of evidence to the contrary (i.e. an organizational intention that the cheque lacked commercial validity), the company's intention to pay the payee is presumed[9].

If the bank cannot prove that the drawer did not subjectively intend to pay the payee, it may still rely on section 20(5) by demonstrating that the payee was non-existent. This is an objective analysis, which requires the bank to prove that the payee was neither (a) a legitimate creditor of the company, or (b) could not be reasonably mistaken for a payee with an established relationship with the drawer[10]. The idea behind this analysis is that drawers should be able to detect and prevent cheques from being made out to entities to whom it owes no debt.

In *Teva*, the bank was unable to prove that the payees were either fictitious or non-existent, despite the fact that the actual "payees" were merely creations of the fraudster employee who happened to share the same or similar names with legitimate creditors of the company. The payees were not fictitious as the company's intention to issue cheques to the entities was presumed to be genuine. The bank did not present evidence to dispute this presumption. The payees were not considered non-existent because they could be reasonably

[4] *Rouge Valley Health System v TD Canada Trust*, 2012 ONCA 17 at para 11; *Bank of Nova Scotia v Toronto Dominion Bank* (2001), 145 OAC 106 (ONCA), at para 15.
[5] *Teva Canada Ltd. v Bank of Montreal*, 2016 ONCA 94, at para 87.
[6] [1996] 3 SCR 727.
[7] [1977] 2 SCR 456.
[8] *Teva*, supra note 1 at para 51.
[9] *Ibid*, at paras 52-53.
[10] *Ibid*, at para 56.

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mistaken as an entity with which the company had an established commercial relationship. As a result, section 20(5) did not provide a defence to the banks, who were liable for conversion.

Implications

Teva does not represent a major shift in the interpretation of the *Bills of Exchange Act*. Rather, *Teva* simply reiterates that the subjective intention of the drawer is a necessary consideration when apportioning liability for fraudulent cheques. Critics of this approach, including the dissenting justices, suggest that a focus on subjective intentions may cause uncertainty within Canada's bills of exchange system[11]. Absent a clear statement by the drawer that the impugned cheque was created to misrepresent the appearance of a genuine transaction, it is difficult to anticipate what evidence would satisfy the "fictitious" standard described by Justice Abella. On a few occasions, the dissenting justices commented on how cumbersome and impractical it would be to obtain such evidence[12].

Nonetheless, the majority felt that, as the primary beneficiary of the bills of exchange system, banks should only escape liability for negotiating fraudulent cheques in a limited number of situations:

> *Banks are well-situated to handle the losses arising from fraudulent cheques, allowing those losses to be distributed among users, rather than by potentially bankrupting individuals or small businesses which are the victims of fraud.*
>
> …
>
> *If Parliament has concerns about the way this Court has balanced these complex policies, it is of course open to it to change the Act.*[13]

In a particularly divergent opinion, the four dissenting justices expressed a strong concern with this rationale:

> *[w]ith respect, it is contrary to public policy to make bank customers the insurers against fraud for companies that fail to exercise effective control over the actions of their employees. Those very bank customers may themselves be small businesses or individuals. Moreover, small businesses are "in an excellent position to detect the fraud at an early stage and in that way minimize the loss" ...Encouraging them to do so is a more sound policy than asking bank customers to backstop sloppy management.*[14]

Regardless of the minority's unease, the majority decision in *Teva* confirms the difficult position that banks face with their customers. While cheque fraud can be limited through extra due diligence when opening accounts and through additional precautionary measures upon the receipt of cheques, these added safeguards are not

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[11] *Ibid*, at para 80.
[12] *Ibid*, at para 118.
[13] *Ibid*, at paras 67, 71.
[14] *Ibid*, at para 132. It is worth noting that many sophisticated companies are insured against cheque frauds committed by its employees. In situations where a bank was successful in defending an claim for conversion under section 20(5), it is likely that the losses would be distributed amongst the customers of the drawer's insurer in the form of increased premiums.

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certain to prevent fraud and may adversely affect customer relations. Although it may be possible for the banks to transfer liability for conversion to the drawer or drawee bank through creative contractual arrangements, these measures would likely be impractical from a business perspective.

The strict nature of liability for conversion combined with the Supreme Court's narrow application of section 20(5) make banks a target for companies who are victims of cheque fraud. While the extinction of paper-based payment systems may be on the horizon (and with it a reliance on more secure electronic systems), absent a legislative initiative to amend section 20(5), banks will continue to bear an increased risk related to third party cheque fraud for the foreseeable future.

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