Collateral Matters

A Banking Law Newsletter

Aird & Berlis LLP
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Supreme Court of Canada to Clarify Banks' Defences to Cheque Fraud

By Timothy Jones*

Fraudulent cheques create significant risks for banks. The law in this area is uncertain and challenging, and does not clearly allocate risks among the various parties to a fraudulent cheque transaction. The forthcoming appeal to the Supreme Court of Canada in the case of *Teva Canada Ltd. v. Bank of Montreal et al*.[1] is an opportunity for clarity.

Introduction

Collecting banks may become liable to the issuer of a cheque (the "**drawer**") if they pay the value of a cheque to a person who was not entitled to possess it. The source of this liability is the ancient common-law tort of conversion (a wrongful act by one person that is inconsistent with the ownership rights of another).

The *Bills of Exchange Act* ("**BEA**") provides a defence to the tort of conversion.[2] This defence is available where banks negotiate cheques which have been issued to "fictitious" and/or "non-existent" payees. However, the case law associated with this defence is deeply technical and often applied inconsistently.

As a result, collecting banks face significant risks from large-scale cheque fraud. If found liable in conversion, they have no recourse against either the drawer company or the drawer bank. Moreover, in Canada, the drawer's negligence has been considered irrelevant to the bank's ultimate liability.[3] Since both the drawer company and the drawer bank are arguably in a better position to discover the fraud than the collecting bank, the fairness of the law here is questionable.

The Teva Case

Teva Canada Ltd. ("**Teva**") and four major Canadian banks were innocent victims of a $5.5-million fraudulent scheme orchestrated by an employee in Teva's finance department. The fraudster issued 63 cheques payable to six companies, two of which were invented and four of which were existing Teva customers. The fraudster and his accomplices opened accounts in the names of these payees at the various Canadian banks, and deposited these fraudulent cheques. Notably, Teva's internal approval process was not followed: the cheques were issued without review or authorization from Teva's directing minds and were signed electronically.

Teva sued the collecting banks in conversion and was granted summary judgment. The Ontario Court of Appeal allowed the banks' appeal, allocating the loss to Teva and relying on s. 20(5) of the *BEA* in holding that all payees were either fictitious or non-existent. The Supreme Court granted leave to Teva's appeal, and is set to hear the matter in early 2017.

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[1] 2016 ONCA 244.
[2] R.S.C. 1985, c. B. 4, s. 20(5).
[3] This is quite different from the position in the United States, where drawers cannot sue in conversion and where liability as between collecting banks and drawer banks is allocated based on relative fault.

The Law of Fictitious and Non-Existing Payees

Cheque fraud case law has been controversial for decades. The applicable principles (drawn from a 1950s textbook) have been criticized as overly complex, internally inconsistent and archaic.[4] The Supreme Court of Canada revisited this issue twenty years ago in *Boma*, but did not simplify matters, instead complicating the test even further and increasing the risk for innocent banks.[5]

Teva is the third of three[6] recent decisions of the Ontario Court of Appeal to deal with s. 20(5) of the *BEA*. Although the Court of Appeal has no power to overturn Supreme Court rulings, each decision carefully sidestepped *Boma* to protect the innocent bank and hold the defrauded company liable, recognizing that a drawer company is typically in a better position than a non-negligent collecting bank to discover employee cheque fraud. However, in doing this, further layers of complexity have been added to an already messy and multivariate legal test.

Questions for the Court

Having granted Teva leave to appeal, the Supreme Court now has the opportunity to clean up this jurisprudence and clearly deal with the following questions of policy and law:

- Can a corporate drawer (i.e. Teva) avoid the losses caused by their own internal fraud?
- If so, is the drawer's negligence (i.e. Teva's failure to follow its own internal cheque approval process) relevant? In other words, is fault relevant to the law's allocation of risk?
- If a non-negligent collecting bank is found liable in conversion, should that collecting bank have a right of action against the non-negligent drawer bank?
- How should the law deal with the particular cheque fraud scheme in *Teva*, where the fraudster opened accounts under a sole proprietorship with the same name as an actual trade payee of the drawer?
- Should the law impose a duty of account verification on bank customers or on drawer banks?

The answers to these questions are highly relevant to financial services professionals. The hearing is slated for February 2017. Hopefully this area of law will be much clearer by the summer.

Relevance for FinTech?

As financial service providers turn increasingly to technology solutions ("**FinTech**"), startups and legacy institutions alike are wrestling with anti-fraud initiatives on electronic platforms. The risks involved are arguably much higher than the risks of cheque fraud, due to the potential for instantaneous speed, global scale and rapid technical innovation.

Canada's patchwork of electronic payment regulation has nothing analogous to the fictitious and non-existing payee defenses in the *BEA*. Accordingly, FinTech intermediaries or banks using electronic payment technologies would seem to have no statutory defenses to the common-law tort of conversion, and the risks of fraud have not been allocated.

Legislators and regulators are catching up to the pace of technological innovation. In Europe, the European Banking Authority has developed draft regulatory standards that require payment service providers to use specific, highly secure authentication techniques.[7] One could speculate that European banks would therefore be liable in conversion for a failure to apply these standards, but that compliance would provide a defence. Unlike in the *BEA,* however, the defence is not expressly provided. Will Canada adopt something similar, or will our regulatory response specifically reduce tort exposure for non-negligent banks and intermediaries?

The *BEA* only applies to written payment instruments,[8] so the outcome of *Teva* will not affect fraud risk for of FinTech companies and other electronic payment intermediaries. That said, as legislators and regulators grapple with allocating risks appropriately among the various parties to electronic payment transactions, the cheque fraud case law could be instructive.

The core policy question at work throughout this jurisprudence is whether non-negligent banks should be penalized for the negligence and/or fraud of drawers simply because the banks have a greater capacity to absorb the costs. This question is at the heart of the *Teva* appeal.

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[4] Benjamin Geva, "The Fictitious Payee Strikes Again: The Continuing Misadventures of BEA S. 20(5)" (2015). Review of Banking and Financial Law, Vol. 30, No. 3, 2015; Osgoode Legal Studies Research Paper No. 33, Vol. 12:7 (2016). Available at SSRN: https://ssrn.com/abstract=2767054. See pp. 578-9.

[5] *Boma Manufacturing Ltd. v. Canadian Imperial Bank of Commerce*, [1996] 3 S.C.R. 727 (S.C.C.) *Boma* added an additional variable to the four-part test, where a payee is not fictitious or non-existent if the drawer of the cheque could have plausibly believed the payee to exist. See para. 60.

[6] The others are *Rouge Valley Health System v. TD Canada Trust*, 2012 ONCA 17, and *Kayani LLP v The Toronto-Dominion Bank*, 2014 ONCA 862 ("*Kayani*"), reversing 2013 ONSC 7967.

[7] Directive (EU) 2015/2366 on payment services in the internal market (PSD2) entered into force in the European Union on January 12, 2016 and will apply as of July 13, 2018. For details on the authentication standards involved, see the Consultation Paper published by the European Banking Authority, dated August 8, 2016: https://www.eba.europa.eu/regulation-and-policy/payment-services-and-electronic-money/regulatory-technical-standards-on-strong-customer-authentication-and-secure-communication-under-psd2.

[8] *BEA* 16(1).

An Opportunity to Build Confidence

Whether in the 'wild west' of FinTech regulatory compliance or in the traditional world of negotiable instruments, banks, intermediaries, customers and policymakers alike would appreciate clear guidance on how the risks of 21st-century payment fraud should be allocated. *Teva* represents an overdue opportunity for the Supreme Court to provide principled leadership on these issues.

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