

• FORGERY LOSSES: BANKS BEWARE! •

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A widespread perception is that a bank is a custodian of depositors' money and is under an obligation to guard it for them. From the legal perspective, this is, of course, untrue. It was settled way back in the 19th century that a bank is a debtor of and borrower from its depositor. In that capacity, the bank is authorized to use money on deposit for its own benefit and profit. At the same time, like a borrower liable on a simple monetary debt, a bank is responsible for the return to the depositor/lender of the entire amount borrowed. A bank is not released from liability for the loss of the money on deposit in circumstances that under the law of bailment would have released a custodian—for example, for lack of fault.

For this reason, a bank is not released from liability for an unauthorized withdrawal from a depositor's account. This is true in Anglo-Canadian law, notwithstanding the customer's fault that facilitated the unauthorized withdrawal. To mitigate losses, banks insert verification clauses into their customer agreements. The leading case in Canada is *Arrow Transfer v. RBC*¹ in which an undertaking by the customer to examine each periodic bank statement and make timely objection was held to be good to make the customer liable for forged items to which the customer had not objected. Had the customer made a timely objection, the forger would have discontinued misdirecting funds out of the account. However, the effect of the verification clause to shift losses to the negligent customer has become subject to erosion through two developments. First, some courts, particularly in Western Canada (e.g., *Cavell Developments Ltd. v. Royal Bank of Canada*),² did not apply *Arrow Transfer* where the bank was negligent. Second, in *S.N.S. Industrial Products Ltd. v. Bank of Montreal*,³ the Ontario Court of Appeal declined to apply to a forged cheque case

a standard verification clause that did not specifically alert the customer to the risk of bearing forgery losses. The judgment did not mention *Arrow Transfer*—a point that must have affected the result in *Oakdale Kitchens Inc. v. Bank of Nova Scotia*,⁴ in which the court declined to give a summary judgment for the bank on the basis of a standard verification clause.

Banks reacted to *Cavell* by incorporating detailed verification clauses addressing specific situations into their agreements with commercial customers.⁵ At the same time, there are certainly limits to the ability of a negligent bank to pass on losses to a customer—no matter how well the clause is drafted. To a similar end, the Singapore High Court in *Jinag Ou v. EFG Bank*⁶ declined to allow a bank to invoke a verification clause where the fraudster was a bank employee.⁷

In the absence of clearer guidance from a higher authority, particularly in light of *S.N.S.*, banks would be well advised to be vigilant and meticulous in drafting tight verification clauses in their customer agreements. However, this option is not available to the collecting bank at which an unauthorized cheque deposit is made and which is not in privity with the holder of the account on which the cheque is drawn. Under s. 48 of the *Bills of Exchange Act*,⁸ the taker from a thief bears the risk of a forged endorsement. Frequently, the taker from a thief is the collecting bank. It was held that s. 165(3) of the *BEA*, dispensing with the endorsement requirement for deposit, does not change the allocation of fraud losses so that, as the taker from a thief, the collecting bank bears the risk of fraudulent and unauthorized transfers of cheques even in the absence of actual forged endorsement. In fact, this would have been a better explanation to *Caisse populaire Desjardins de Côte-des-Neiges v. Toronto Dominion Bank*.⁹ In that case,

the Quebec Court of Appeal treated the fraudulent replacement of payees' names by a fraudster who was not entitled to the cheques and who fraudulently deposited them as a case of material alteration governed by ss. 144–145 of the *BEA*. In any event, when a collecting bank is sued in conversion on the basis of a cheque transferred to it without the authority of its owner, the fault of a third party (such as the holder of the account on which the cheque was drawn) does not play any role in the loss allocation.

Two developments joined to worsen the position of the collecting bank even further. First, a corporate customer whose employee was the fraudster became entitled to sue the collecting bank in conversion. Liability on this tort is strict. Hence no defence could be raised by a collecting bank that dealt with a cheque drawn on the customer's account. In my view, courts are not justified in invoking the tort in favour of the holder of the account from which cheques are drawn and who does not have rights in them as valuable assets. The right to sue in conversion ought to be reserved to a person who claims the cheque, as a tangible item of property, entitling that person to claim the sum of money indicated on it. Most typically, such a person is the dispossessed ex-holder of the cheque.

In *Reidco (86) Ltd. v. BMO Bank of Montreal*,¹⁰ the depositor of a bank draft alleged that the collecting bank wrongfully withdrew the funds paid by the drawee/issuer and forwarded them back to it. The court held for the depositor, *inter alia*, on the basis of the conversion of funds, which is not even recognized as a tort. Rather, action ought to have succeeded on the basis of a breach of a contract alone. In a given case, such mischaracterization of causes of action may prevent a collecting bank from raising contract defences to which it may be entitled.

Second, *Boma Manufacturing Ltd. v. Canadian Imperial Bank of Commerce*¹¹ substantially narrowed down the defence under s. 20(5) of the *BEA*. Under that section, a cheque payable to a fictitious or non-existing person may be treated like a cheque payable to the bearer. It may thus

pass from hand to hand free of adverse claims, and its payment to the “holder/bearer” releases the drawee bank from liability to its customer. Having failed (unjustifiably, I maintain) to convince the court that it ought not to be sued in conversion, as explained in the preceding paragraph, a collecting bank may nevertheless avoid liability in conversion by successfully raising a defence based on that provision.

Traditionally, whether a cheque was payable to a fictitious payee was determined according to the intention of the signer. Conversely, non-existence was deemed to be a fact that was determined objectively. Purporting not to change these rules, *Boma* nevertheless held that, either way, it is the point of view of a guiding mind of a corporate customer that determines whether a cheque is payable to a fictitious or non-existing payee. As a result, the section was made to apply only in case of an internal fraudulent scheme perpetrated by a senior officer of the account-holding corporate customer. However, on that point, some relief may have come to collecting banks from *Rouge Valley System v. TD Canada Trust*,¹² which narrowly understood *Boma* to apply only if the name of the imaginary payee was similar to that of an existing creditor of the corporate customer and known to the guiding mind.

In *Royal Bank of Canada v. Société Générale*,¹³ the Ontario Court of Appeal opened the door to the possibility that a drawer and account holder will be prevented by its negligence from setting up a forged endorsement plea against a collecting bank. Unfortunately, more recently and without even mentioning *Société Générale*, a different panel of the same court closed the door to this possibility in *Teva Canada Ltd. v. Bank of Montreal*,¹⁴ where the strict liability nature of the conversion tort was highlighted.

So far, Canadian courts have declined to accept Justice Laskin's (as he then was) invitation in *Arrow Transfer* to fasten a duty of care on bank customers (albeit he was speaking then in the context of verification agreements). Further, no court in Canada has had the opportunity to con-

sider a collecting bank's right to meet the conversion action of the holder of the account from which the cheque emanated by raising a contractual defence available to the drawee bank against the account holder. I would not put much faith in the success of that defence and yet recommend to a collecting bank to get an assignment of the drawee bank's contractual rights. Nor do I have confidence in case law to sort out the mess. At this point, banks are to rely on properly drafted contracts and effective lobbying designed to achieve a legislative change to allocate losses to whoever was in a position to prevent or at least minimize them.

[*Editor's note:* **Benjamin Geva**, counsel at Torys LLP, is a member of Torys' Payments and Cards Practice. He is a leading international legal expert on payment instruments and methods, bank deposits and collections, credit transactions and facilities, electronic banking, and payment and settlement systems.

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¹ [1972] S.C.J. No. 64 (S.C.C.) [*Arrow Transfer*].

² [1991] B.C.J. No. 614 (B.C.C.A.).

³ [2010] O.J. No. 2934 (Ont. C.A.) [*S.N.S.*].

⁴ [2012] O.J. No. 2206 (Ont. S.C.J.)

⁵ Keith W. Perrett, "Account Verification Clauses: Should Bank Customers Be Forced to Mind Their Own Business?" (1999), 14 *Banking and Finance Law Review* 245.

⁶ [2011] SGHC 149.

⁷ Sandra A. Booyesen, "Verification Duties, Conclusive Evidence Clauses, and Fraud by Bank Employees" (Aug 2012), 27.4 *Banking and Finance Law Review* 687.

⁸ R.S.C. 1985, c. B-4 [*BEA*].

⁹ [2011] Q.J. No 7635 (Qc. C.A.).

¹⁰ [2011] O.J. No. 1753 (Ont. S.C.J.—Sm. Cl. Ct.).

¹¹ [1996] S.C.J. No. 111 (S.C.C.) [*Boma*].

¹² [2012] O.J. No. 81 (Ont. C.A.).

¹³ [2006] O.J. No. 5081 (Ont. C.A.).

¹⁴ [2012] O.J. No. 3098 (Ont. C.A.).