

Supreme Court of Canada Rules Banks Liable for Conversion of Cheques

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When the employee of a large corporation defrauds their employer through a fraudulent cheque scheme, should the banks which paid out on the cheques be liable to the defrauded employer for conversion?

This was the issue recently before the Supreme Court of Canada in *Teva Canada Ltd. v. TD Canada Trust et al.*, 2017 SCC 51.

The facts of the case were as follows. An employee of Teva undertook a fraudulent cheque scheme whereby he drafted false requisition forms for cheques payable to business entities with the same or similar names as actual existing customers of Teva. Teva's accounting department issued the cheques. The employee registered sole proprietorships in the names of the payees on the cheques and opened bank accounts at several banks where he would deposit the cheques. Ultimately, the employee deposited a total of 63 fraudulent cheques and obtained funds totalling \$5,483,249.40.

Teva claimed against the banks involved in negotiating the fraudulent cheques for conversion, a strict liability tort involving the wrongful interference with the goods of another. The banks defended on the basis that the cheques were made payable to "fictitious" or "non-existing" persons, and therefore payable to the bearer.

Under section 20(5) of the *Bills of Exchange Act*, R.S.C. 1985, c. B-4 (the "Act"), where the payee of a negotiable instrument is "fictitious" or "non-existing", the instrument may be treated as payable to bearer. A bank will not be liable for conversion if it pays out on a fraudulent cheque payable to bearer.

At the Superior Court level, the motion judge on a summary judgment motion brought by Teva found in favour of Teva holding that there were no fictitious or non-existing persons. Whitaker J. found that there was "a rational basis for concluding that the cheques were apparently made payable to existing clients" of Teva. Thus, the banks involved were liable for conversion.

The Ontario Court of Appeal overturned the motion judge's decision on the grounds that the payees were either fictitious and/or non-existing. It found that the names of two payees were invented by the fraudster and therefore non-existing, and that four payees with identical names to existing customers of Teva were fictitious.

In its 27 October 2017 decision, the Supreme Court of Canada restored the judgment of the motion judge finding in favour of Teva. In a 5-4 decision authored by Abella J. (dissenting opinion authored by Cote J. and Rowe J.), the Court upheld decades of jurisprudence interpreting s. 20(5) of the Act and endorsing the two-step test applied under that section set out in the Court's previous decision in *Boma Manufacturing Ltd. v. Canadian Imperial Bank of Commerce*, [1996] 3 S.C.R. 727.

Under existing jurisprudence, the test applied in connection with the "fictitious" or "non-existing" payee inquiry is a two-part analysis:

- First, the subjective fictitious payee inquiry asks whether the drawer intends to pay the payee. The drawer of the cheque is presumed to intend for the named payee to receive the proceeds of the fraudulent instrument. Yet, if the bank can prove that the drawer of the cheque did not intend to pay the payee, the payee is fictitious within the meaning of s. 20(5) of the Act and the bank will not be liable for conversion. The rationale here is that if the drawer did not intend to pay the payee, it is estopped from seeking recovery from the bank. For example, this prevents recovery by the drawer of a cheque for a fraud in which it was involved.

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- Second, the objective non-existing payee inquiry asks whether (1) the payee is a legitimate payee of the drawer, or (2) the payee could reasonably be mistaken for a legitimate payee of the drawer. The analysis is concerned with whether the payee is non-existing from a factual perspective without reference to subjective intent. Accordingly, if the payee is not an established client of the drawer, or could not reasonably be mistaken as an established client, the payee is non-existing and the bank will not be liable for conversion.

Abella J. and her concurring colleagues declined to create a new version of the test, which the dissenters endorsed. Rather, Abella J. held at paragraph 58:

“That is the current state of the law. Unlike my colleagues, I see no reason to create a new version of the false payee defence whereby a payee would be “fictitious” when there is no real underlying transaction or debt. This overrules this Court’s decision in *Concrete Column*, and its confirmation in *Boma*. It also nullifies Iacobucci J.’s approach to “non-existent” payees in *Boma* and replaces it with an approach whereby a payee reasonably mistaken by the drawer for a payee with an established relationship would be considered fictitious on the basis that any payee who is not factually real cannot have an underlying transaction with the drawer. A payee would therefore only be deemed “non-existent” when the payee does not in fact exist at the time the cheque is drawn. This means that only in rare cases would there be liability for the banks, namely where the converted cheque is drawn to the order of a real person entitled to the proceeds.”

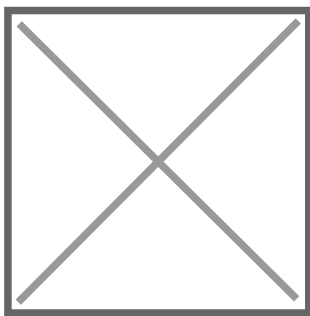
Applying the test to the facts of the case, four of the payees were found to be existing customers of Teva, and two of the payees which were invented could reasonably be mistaken to be customers of Teva (given their pharmaceutical-related names). Considering the “commercial realities” of the cheque-issuing process of a large corporation such as Teva, the Court found that the presumption that Teva intended to pay the payees at issue was not rebutted. Further, the payees were real customers or had names which were “very similar” to names of Teva’s real customers. Accordingly, the majority held that the payees were neither fictitious nor non-existing and the banks’ defences to the conversion claim failed.

Rooted in Abella J.’s analysis is a clear consideration as to which of the innocent parties to the fraud – the drawer or the bank – is better able to absorb the risk of fraud. Her Honour stated that “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”.

On its face, the decision can be regarded as a win for the customers of banks. However, the reality of the matter is that the risks absorbed by the bank might ultimately be passed on to the customer through increased fees for banking services.

(This blog is provided for educational purposes only, and does not necessarily reflect the views of Gardiner Roberts LLP).

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