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REALITY CHEQUE: BANK LIABILITY FOR FRAUDULENT BILLS OF EXCHANGE

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INTRODUCTION

Where an insured is the victim of a fraudulent cheque scheme, fidelity insurers seeking to recover monies paid out under their policies often find that the perpetrator has very little in the way of assets to satisfy a judgment in a subrogated action. Yet it is an often overlooked fact that the bank which honoured the fraudulent cheques may also be liable for the stolen funds. As there may be very short notice periods in play in these cases, it is important that adjusters and other individuals who are involved in the early stages of these claims be alert to a bank's potential liability.

In Canada, the liability of banks that act on forged cheques is governed by a mix of the common law and the federal *Bills of Exchange Act* (the *"Act"*).[1] This Alert! discusses the legal reasons for placing liability on banks in these cases, and considers some common defences that the subrogation professional may encounter when pursuing this avenue of recovery.

UNDERSTANDING THE TERMINOLOGY:

The term **"bill of exchange"** refers to a negotiable instrument such as a cheque or bearer bond. As a brief introduction to this area of law, it may be useful to know that, typically, there are three parties to a bill of exchange:

(1) the person who writes the cheque is the **"drawer"** or **"payer"**;

(2) the entity upon whom the cheque is drawn is the **"drawee"**; and

(3) the person to whom a sum of money is to be paid is the **"payee"**.

Translated into everyday affairs, a customer of the bank (the drawer) writes a cheque to his bank (the drawee) to withdraw money from his bank account to pay a creditor (the payee).Where a cheque is made payable to "cash", the payee is, essentially, the bearer of

the cheque.

Generally speaking, the term **"signature"** may refer to either the drawer's authorizing signature or the payee's endorsement. An **"endorsement"**, however, refers specifically to a payee's signature on the back of the cheque. The distinction is quite important, as the liability of the bank may depend on whether it was the *drawer's signature* or the *endorsement* that was forged.

SCENARIO 1: THE DRAWER'S SIGNATURE IS FORGED

At common law (*i.e.*, judge-made law, as opposed to legislation), a drawee bank is deemed to know the true signatures of its customers. If a customer's signature is forged and the bank makes a payment on that forgery, the bank must bear the loss. This common law has been codified in s. 48(1) of the *Act*, which provides that where a signature on a cheque is forged, the drawee bank has no authorization to enforce payment on a cheque.[2] The *Act* makes a bank *strictly liable* to the drawer if it makes payment on a forgery. That is, no matter how convincing the forgery, the bank will be held responsible for making payment.

Importantly, since a bank is held *strictly liable*, the bank cannot try to hold its customer responsible or "contributorily negligent" for a portion of the loss by using the argument that a customer *could have* detected the fraud if it had maintained a better system of internal accounting controls to detect and minimize loss through forgery. Similarly, Canada's Supreme Court has held that customers do not owe duties to their banks to examine their bank statements and vouchers with reasonable care and to report any discrepancies to the bank within a reasonable period of time.[3]

COMMON DEFENCES TO A FORGED SIGNATURE

a) Preclusion

Section 48(1) of the *Act* does give banks a narrow defence to liability if a bank can establish the defence of "preclusion". In order to make this defence, a bank is required to prove that its customer has somehow been negligent (that is, failed to use reasonable care) in the *mode of drawing the cheque* and that this was the proximate cause of the loss. Preclusion might also occur, for example, where a drawer signs the cheque but leaves the amount blank, or delays in reporting the forgery to the bank.[4] However, the customer must have had *actual* knowledge of the forgery, not merely imputed knowledge.[5]

b) The Verification Clause

As a result of the foregoing, it has become standard practice for banks to limit their liability to their customers by including a "verification clause" in account agreements with their customers. A verification clause requires an account holder to notify his or her bank of any errors in a monthly statement within a specified period (usually 30 days) from the time that the monthly statements are received by a customer, failing which the customer is deemed to accept the account entries as correct.

Example:

The effect of verification clauses is illustrated in the Supreme Court of Canada case of *Arrow Transfer Co. Ltd. v. Royal Bank of Canada*. The case that involved a claim against RBC, with regard to a number of forged cheques. The cheques were prepared by the plaintiff company's Chief Accountant, who forged the signatures of the plaintiff's officers on the cheques. The plaintiff had signed a verification agreement with the RBC which specified that it was the responsibility of the drawer (customer) to verify the accuracy of all bank statements and notify the bank of any errors or omissions within 30 days of the receipt of such statements. If no such notification was given, the bank would then be free from any claims against it in respect of the account. The verification agreement also contained a fairly standard exception that the verification clause did not apply to "forged or unauthorized *endorsements*".

The majority of the Supreme Court held that the forged cheques paid by the RBC were not payments made on forged "endorsements" which, as discussed above, refers to the payee's signature on the back of a cheque. Instead, it was the signature of the *drawer* that had been forged. The majority held that the verification agreement therefore provided the bank with a complete defence to the action. Since the plaintiff had not provided the bank with timely notice of the forgery as per the verification agreement, it therefore had no action against the bank.

SCENARIO 2: THE PAYEE'S ENDORSEMENT IS FORGED

In addition to s. 48(1) of the *Act*, the tort of "conversion" may also be pleaded against the bank in cases where a payee's *endorsement* is forged. The tort of conversion involves wrongful interference with the *goods* of another, such as by taking, using or destroying the goods in a manner inconsistent with the owner's right of possession. Just as s. 48(1) of the *Act* imposes strict liability on a bank for debiting a customer's account on a forged cheque, so does the tort of conversion; it is no defence that the bank was "innocent" of any intent to wrongfully convert the owner's property, nor is it a defence that the bank was contributorily negligent.

Because conversion deals with personal property, or "goods", it may seem strange that a bank could be liable for conversion of a cheque. However, a cheque can actually be regarding as being made up of two parts:

(1) a **"goods"** part; and

(2) a **"right of action"** part.

The *real* value of a cheque is the "right of action" part - the right to receive payment from a bank of the sum for which a cheque is drawn. However, it is the "goods" part of the cheque - the paper and ink on which it is printed - that will allow a person to sue for conversion. Conversion is triggered because of the fact that the cheque is a tangible piece of property, even if it is simply a paper document. Where a payee, who is the rightful owner of the cheque, discovers that a third party has forged his endorsement and received cash from a bank, the bank has wrongfully "converted" the payee's property - the cheque - albeit unintentionally. The

law will not allow the bank to simply hand back the spent cheque to the payee since it is now valueless. The bank will be liable in damages for the act of conversion with the measure of damages being the value

Why Doesn't Conversion Apply Where a *Drawer's Signature* is Forged?

A bank cannot be held liable for conversion where a drawer's signature is forged because of what is referred to as the "worthless paper" defence. In order to make a claim for conversion, the plaintiff must show that the bank has converted its valuable property. The problem is that where an authorizing signature is forged, the cheque itself is not valuable property. It is still property, in the sense that any piece of paper is technically "property", but there is no true "right of action" part attached to it to give it value. Since a bank which honors a cheque with a forged signature has not converted any valuable property, but only a worthless piece of paper, it could not be held liable for conversion. The bank's liability would instead arise from its debiting of its customer's account without authority, for which it could protect itself through a verification clause, as discussed above.

COMMON DEFENCES TO A FORGED ENDORSEMENT

a) Late Notice

Section 49(3) of the *Act* requires that a person who is seeking to recover monies paid out under a forged endorsement must give notice to the bank, in writing, that the endorsement is forged or unauthorized within a "reasonable time". As the definition of "reasonable time" is subject to interpretation, it is always important that written notice be given to the bank as soon as possible.

b) The "Fictitious or Non-Existing Payee" Defence

If a drawer makes a cheque payable to a **fictitious** or **non-existing** person, then the presence or absence of a legitimate or forged endorsement becomes irrelevant.[6] In such cases, the cheque is treated as being payable to "bearer".[7] In such cases, no endorsement is required and the bank is not liable for making the payment. In other words, a person who, for their own purposes, makes a cheque payable to someone other than a real and existing person, will lose the protections that he or she would otherwise be afforded under the *Act*.

CONCLUSION

Upon receiving notice of a claim involving forged cheques, the subrogation professional's first steps should always include the following:

1. Send the implicated bank(s) **written notice** and particulars of the forged cheques;

2. Inquire as to whether there is a verification agreement in place with respect to the accounts in question; and

3. Retain a lawyer experienced in banking law and subrogation in order to investigate and protect the insurer's interest.

Although the above is intended as a very general summary of some of the legal issues that may arise in these types of claims, it is by no means exhaustive. It should be emphasized that these actions often raise complicated legal issues that are not always intuitive, and require handling by experienced counsel.

Cozen O'Connor's experience in litigating all forms of commercial and insurance-related matters, and our expertise in the area of subrogation and recovery actions, is available to be deployed for the benefit of your company to assist in the recovery of subrogated claims. For additional information concerning Cozen O'Connor's Subrogation and Recovery Program, please contact:

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ENDNOTES

1. R.S.C. 1985, c. B-4 [*"Act"*].
2. Section 48(1) of the Act provides as follows:
   > Subject to this Act, where a signature on a bill is forged, or placed thereon without the authority of the person whose signature it purports to be, the forged or unauthorized signature is wholly inoperative, and no right to retain the bill or give a discharge therefore or to enforce payment thereof against any party thereto can be acquired through or under that signature, unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery for want of authority.
3. *Arrow Transfer Co. Ltd. v. Royal Bank of Canada* (1972), 27 D.L.R. (3d) 81 (S.C.C.).
4. The defence of preclusion is explained by Justice Feldman in the Ontario Court of Appeal case of *Nesbitt Burns Inc. v. Canada Trustco Mortgage* (2000), 131 O.A.C. 85 (Ont. C.A.).
5. *Ibid*.
6. See, for example, *Boma Manufacturing Ltd. v. Canadian Imperial Bank of Commerce*, [1996] 3 S.C.R. 727 (S.C.C.).
7. Section 20(5) of the *Act, supra* note 1.