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The SCC considers who bears the risk of a fraudulent cheque: the drawer or the bank?

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In this Update

- In *Teva Canada Ltd. v. TD Canada Trust*, the Supreme Court of Canada clarified the "fictitious" or "non-existent" payee defence to the tort of conversion under the *Bills of Exchange Act* (*BEA*).
- The Court rejected an objective approach to determining when a payee is fictitious, in favor of an approach that considered the drawer's intent.
- The Court accepted that "non-existent" payees included those payees who the drawer could have reasonably mistaken for a legitimate payee.

Cheque fraud happens. Sometimes it happens through a scheme in which both the drawer of the fraudulent cheque and the collecting bank that negotiates the cheque are completely innocent victims of a third party. In such instances, which of these innocent parties should bear the loss arising from the fraud? The Supreme Court of Canada grappled with this difficult question in *Teva Canada Ltd. v. TD Canada Trust* (*Teva*) and, in a 5-4 split decision, confirmed the following:

(a) it is the subjective intention of the drawer to pay the payee that determines whether a payee is "fictitious"; and

(b) a payee will not be found to be "non-existent" if the payee could reasonably have been mistaken by the drawer for a legitimate payee.

This results in a greater risk of cheque fraud being allocated to the collecting banks as it limits the circumstances when collecting banks will be able to rely on section 20(5) of the *BEA* as a defence to an action for conversion.

Background

Teva involved a fraudulent cheque scheme carried out by an employee (M) at his place of employment. Using cheque requisition forms, M induced his employer into issuing cheques made out to payees with names that were similar or identical to names of the employer's real customers, to whom no debt was owed. M then registered the payees as the business names of sole proprietorships and opened up bank accounts for each sole proprietorship at several banks. After depositing the fraudulent cheques at the collecting banks, M absconded with funds totalling $5,483,249.40.

The employer filed an action for conversion against the collecting banks for negotiating M's fraudulent cheques. Importantly, since conversion is a strict liability offence, the drawer is not required to establish negligence on the part of the collecting bank. The elements of the tort of conversion will be satisfied where a bank deals with a cheque under the direction of a person not authorized, by collecting the cheque and making the proceeds available to someone other than the person rightfully entitled to possession, often on the basis of a forged or absent endorsement. However, there is an effective statutory defence available under s. 20(5) of the *BEA*, which states that if "the payee is a fictitious or non-existent person, the [cheque] may be treated as payable to the bearer."

Section 20(5) of the *BEA* therefore acts as a statutory defence to a claim for conversion because cheques treated as payable to the bearer are negotiated by mere delivery – endorsement of the cheque is not required. In *Teva*, this meant that if M's fraudulent cheques were found to be payable to either a "fictitious" or "non-existent" payee, then the banks would not be liable for conversion because they were entitled to negotiate the cheques in favour of M as the bearer (i.e., M would have been a holder in due course entitled to possession of the proceeds). In contrast, if the payees on M's cheques were neither "fictitious" nor "non-existent," the banks would be liable for conversion because they negotiated the cheques in favour of M without the requisite endorsement.

Since "fictitious" and "non-existent" are not defined terms in the *BEA,* the key issue in *Teva* in both the lower courts and at the Supreme Court was the meaning to be given to these terms and their application to the facts of this case.

Two approaches to determining whether a payee is "fictitious" or "non-existent"

The Court in *Teva* was split, with the majority and minority reasons endorsing competing approaches for determining whether a payee is "fictitious" or "non-existent" for the purposes of s. 20(5) of the *BEA*.

Approach of the majority

The test endorsed in the majority reasons, authored by Justice Abella, involves two inquiries, one subjective and one objective:

- The subjective "fictitious" payee inquiry asks whether the drawer intended to pay the payee. If the bank shows that the drawer had no such intention, the payee is "fictitious" and the bank is not liable.
- The objective "non-existent" payee inquiry asks whether the payee is (1) a legitimate payee of the drawer; or (2) a payee who could reasonably have been mistaken by the drawer for a legitimate payee. If either is true, then the payee does not meet the requirements for being found to be "non-existent" for the purposes of s. 20(5) of the *BEA*.

Justice Abella described three principal reasons for adopting this approach to determining whether a payee is "fictitious" or "non-existent":

1. It aligned with the current state of the law and there were no compelling reasons to break from the existing jurisprudence by creating a new version of the test.
2. It was reflective of the prior common law test, which the *BEA* was intended to codify, in

that it incorporated the knowledge and intention of the drawer in determining whether such drawer should be estopped from denying the cheque be payable to the bearer.

3. It reflected sound public policy in allocating risk to the banks because banks may distribute losses from fraudulent cheques among their many users and are therefore in a better position to handle these losses as they arise.

In applying this test, the majority found that the payees on M's fraudulent cheques were neither fictitious (because the employer intended to pay these payees notwithstanding that no legitimate debt was owed) nor were they non-existent (because the employer could reasonably have mistaken the payees for its real customers). The majority therefore found the banks liable for conversion.

Approach of the dissent

In contrast, the test endorsed in the reasons of the four dissenting justices, authored by Côté and Rowe, is entirely objective:

- First, a payee will be "fictitious" where the payee is not entitled to the proceeds of the cheque because there is no real underlying transaction or debt.
- Second, a payee will be "non-existent" where the payee does not in fact exist at the time the instrument is drawn (regardless of the knowledge or belief of the drawer).

Justices Côté and Rowe supported this approach as a break from recent judicial authority, arguing that the inclusion of the drawer's intention into the test for fictitious payees is the product of an early misinterpretation of s. 20(5) of the *BEA* and that a pure objective approach would be more reflective of a plain meaning interpretation of this provision. This textual approach should be preferred when interpreting the *BEA* because the *BEA* intended to modify, not merely codify, the common law. The dissenting justices also formed the view that an objective approach reflects sound public policy because it would allocate the risk of losses from cheque fraud to the party in the best position to detect and minimize this risk (i.e., the drawer). In contrast, according to the dissenting justices, the majority approach would inappropriately allocate this risk to the banks with the presumption that its customers may effectively act as the downstream insurers for such cheque fraud.

In applying this test, the dissenting justices found that the payees on M's fraudulent cheques were either fictitious (because there was no real transaction between the payee and the employer) or non-existent (because the payee did not exist at the time the cheque was drawn). As such, the dissenting justices would not have found the banks liable for conversion.

Implications

The decision in *Teva* allocates a greater risk of loss to collecting banks in cases of fraudulent cheques because it will be more difficult for the banks to rely on the defence that a payee is "fictitious" or "non-existent." However, the decision in *Teva* reflects a preservation of the status quo. Justice Abella emphasized that *Teva* is in line with judicial authority that has "served the commercial world for 40 years without serious complaint from that world." Nevertheless, since *Teva* confirms that the "fictitious" or "non-existent" payee defence to conversion under the *BEA* is dependent on the drawer's subjective intention to pay or its reasonable understanding of the existence of the payee, it may also encourage banks to adopt more rigorous policies when negotiating cheques payable to corporate entities. As suggested by both the majority and the dissent, this may ultimately result in higher costs for banking consumers.