Financial Services Litigation Bulletin

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"Check That Cheque" or be Left Holding the Bag

A recent Ontario Court of Appeal decision has highlighted again the perils facing banks which unwittingly negotiate fraudulent cheques. In *Westboro Flooring and Décor Inc.* v. *Bank of Nova Scotia,* the Court pinned the entire loss flowing from a fraudulent cheque scheme on the fraudster's bank (the "Collecting Bank"), which had allowed the fraudster to deposit the fraudulent cheques into his account.

In finding the Collecting Bank liable, the Court of Appeal rejected a number of defences typically asserted by collecting banks when sued by victims of cheque fraud. Although this decision may make it more difficult for collecting banks to defend these claims, it also suggests that a collecting bank may be able to escape liability by ensuring that the name of the payee on the fraudulent cheque is identical to the name of the depositing accountholder.

The *Westboro* case centred on the activities of a fraudster who had been employed as a bookkeeper (the "Fraudster") by the plaintiff corporation (the "Plaintiff"). The Plaintiff had a supplier named "Terry Govas Ottawa-Hull Carpet Ltd.", which name was abbreviated to "Ottawa Hull Carpets" on cheques paid to it by the Plaintiff. The Fraudster registered a business name, "Ottawa Hull Carpet Sales" and opened a bank account in the name of "Ottawa Hull Carpet Sales" at the Collecting Bank. The Fraudster then prepared a number of cheques payable to Ottawa Hull Carpet, which he had his employer sign and which the Fraudster then deposited into his Ottawa Hull Carpet Sales account. By the time that the scam was discovered, the Fraudster had defrauded his employer of $225,000 and had no assets. The Plaintiff thus sought to recover its losses from the Fraudster's bank, the Collecting Bank.

The Court concluded that the Collecting Bank was *prima facie* liable to the Plaintiff for the tort of conversion, (i.e. wrongful interference with the goods of another) on the grounds that the cheques remained the property of the Plaintiff as they were not created for legitimate debts of the Plaintiff, and therefore when the Collecting Bank processed the cheques, it paid money to the Fraudster, which rightfully belonged to the Plaintiff.

As noted above, in finding for the Plaintiff, the Court rejected a number of defences asserted by the Collecting Bank. For example, the Collecting Bank alleged that it should not be found liable as it had committed no wrongful act; it had been duly diligent when it opened the Ottawa Hull Carpet Sales account and when it had accepted the cheques for deposit. There were no forged or missing endorsements as there had been in earlier cases, which had found collecting banks liable. Also, the Collecting Bank noted that the Plaintiff had created a climate conducive to fraud by delegating complete cheque authorization authority to the Fraudster. The Court rejected these arguments and held the Collecting Bank liable even though it had committed no wrongful act.

In defending against the Plaintiff's claim, the Collecting Bank also sought to rely on provisions of the *Bills of Exchange Act* (the "BEA"), which provide that where the payee of a cheque is a fictitious or non-existent person, the cheque may be treated as payable to its bearer. The Collecting Bank asserted that the payee of the cheque "Ottawa Hull Sales" was not an individual or a corporation and therefore was non-existent.

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In rejecting this defence, the Court followed a decision of the Supreme Court of Canada[1] which held that a payee is neither non-existent nor fictitious if the account holder on which the cheque was drawn honestly believed that the cheque was made out for an existing obligation to a real entity known to it. The Court of Appeal found that the Plaintiff met this test because the Plaintiff signed the cheques believing that it was paying an existing supplier, even though the name on the cheque was not that supplier's actual name.

The Collecting Bank also asserted that it should be protected from liability because it was a holder in due course of the cheque under the BEA. The BEA states that where a cheque is delivered to a bank for deposit to the credit of a person and the bank credits him with the amount of the cheque, the bank acquires all the rights and powers of a holder in due course. The Court held that the Collecting Bank was not a holder in due course, because the name of the payee on the cheque was different from that of the account holder. In so finding however, the Court suggests that, had the payee name on the cheque been the same as the account holder's name, the Collecting Bank would have been entitled to rely on the holder in due course defence. This decision thus makes it vitally important for Collecting Banks to check that the payee name is identical to the name of the accountholder, into whose account the cheque is deposited.

Implications of Decision

Westboro is one of a series of recent cases in which the Courts have held that, as between the two innocent parties, the victim of a cheque fraud and the collecting bank, it is the latter that its likely to be required to bear the loss associated with the fraud. *Westboro* appears to provide a narrow exception to that rule by suggesting that the holder in due course defence may be available if the fraudulent cheque is deposited into the account of a person with the identical name as the payee of the cheque. The lesson from *Westboro* thus is that where there is a cheque fraud, there is a strong likelihood that the collecting bank will be left holding the bag. One way to address that risk (apart from a closer vetting of those who open accounts) is to check cheques to ensure that the name of the payee on the cheque is identical to the account holder's name.

Recent cases[2]

"I didn't know what I was signing" Doesn't cut it in Guarantee Case

The Business Development Bank of Canada, ("BDBC") moved for summary judgment on the defendant's guarantee. The defendant raised the defence of *non est factum*, which in effect means that he did not understand what he was signing. In granting summary judgment the court found that the defendant was an experienced business person who understood the difference between corporate and personal liability and the nature of guarantees. The court also found that the defendant was either careless in executing the guarantee or a victim of fraud by one of his co-defendants, and in either case, BDBC was an innocent third party which owed no fiduciary obligations to the defendant.

Business Development Bank of Canada v. 1458314 Ontario Inc. *{2005} O.J. No. 203 (S.C.J.)*

Disputing Priority May Cost you More Than you Think

An application for directions was made by the TD Bank ("TD"), Cattlemen's Financial Corp. ("CFC") and Farm Credit Corporation ("FCC") with regard to who was responsible for costs incurred by a receiver for feeding and caring for cattle during a period of dispute between these parties. TD obtained a receivership order over the debtor and engaged in negotiations with CFC and FCC regarding a priority dispute which lasted several days. The court found that as TD had the right to sell the cattle immediately and attempted to do so, FCC and CFC should bear the costs of feeding the cattle during the period in which they disputed TD's security.

Farm Credit Corp. v. Toronto Dominion Bank *{2005} A.J. No. 5 (Q.B.)*

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[1] *Boma Manufacturing* v. *Canadian Imperial Bank of Commerce {1996} 3 S.C.R. 727 (S.C.C.)*

[2] This bulletin was written with the assistance of Sandra Sbrocchi, Student-at-Law

Court Refuses to Certify $100 Million Currency-X Class Action

A class action was brought against the Toronto-Dominion Bank ("TD") regarding the non-disclosure of a 1.65% fee on credit card currency exchanges. In finding that this matter did not qualify for certification the Court held that it would be impossible to know how each individual cardholder would have acted had they known of the fee and therefore, it was necessary for there to be an individual determination for each card holder.

Cassano v. Toronto-Dominion Bank, *{2005} O.J. No. 845 (S.C.J.)*

Secondary Credit Card User Held Not Liable for Charges of Primary User

Mr. Bell was the primary user, and Mrs. Bell the secondary user (the "Authorized User"), of a Visa card. The Canadian Imperial Bank of Commerce ("CIBC") brought summary judgment proceedings against both Mr. and Mrs. Bell with regards to the amounts outstanding under both the primary and secondary cards. The relevant provisions of the card holder agreement provided that the primary user was "liable for all use of and charges to the visa account, including use by the Authorized User(s)", whereas the provisions for the Authorized User stated that it "will be liable for all charges on my card and my other use of the visa account". The court held that, as CIBC was a large and sophisticated institution which obtained expert legal advice in drafting the standard form agreements, the court could not support a reading that would find the secondary user liable for the obligations of the primary user.

Canadian Imperial Bank of Commerce v. Bell Estate, *{2005} O.J. No. 323 (S.C.J.)*

Lenders Denied Receiver in CCAA Proceeding

Approximately 3 weeks after the debtor filed for protection under the *Companies' Creditors Arrangement Act*, the secured lenders moved to appoint a receiver. In denying the application the court found that the secured lenders had not provided management with an opportunity to prepare a viable restructuring plan and that the increase in professional fees which would accompany such an appointment would negatively affect the survival potential of the business. The court granted a one month extension to the CCAA proceeding in order to allow the company to attempt to restructure.

Community Pork Ventures Inc. v. Canadian Imperial Bank of Commerce, *{2005} S.J. No. 24 (Q.B.)*

Joint Covenantor's Payment Reactivates Limitation Period

The three defendants entered into a mortgage with the TD Bank ("TD"). For over 10 years two of the defendants made no payments and commencing in 1991 the mortgage was in default. From 1997 to 2003 several payments were made by the third defendant. The court held that, as all of the defendants had received the benefits of the payments, they also bore the burdens which such payment entailed, including the reactivation of the limitation period.

Toronto-Dominion Bank v. Rohatyn, *{2005} O.J. No. 473 (S.C.J.)*

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

Who We Are

Hilary E. Clarke
Partner
Direct Line: 416.865.7286
E-mail: hilary.clarke@mcmillanbinch.com

Hilary is a corporate-commercial litigator whose practice has focused on financial institutions, pensions and bankruptcy and insolvency litigation for Canadian and US clients. Hilary has represented financial institutions in a wide range of disputes including claims of lender liability, auditors' negligence, breach of fiduciary duty, fraud, breach of contract, misrepresentation, breach of trust, claims under the *Bills of Exchange Act,* priority disputes and actions to recover debt.

Brett G. Harrison
Associate
Direct Line: 416.865.7932
E-mail: brett.harrison@mcmillanbinch.com

Brett is an associate in the firm's Commercial Litigation and Corporate Restructuring Groups. He has a general corporate commercial litigation practice with an emphasis on financial institution litigation, insolvency and restructuring, debtor/creditor disputes and fraud. Brett has been involved in a number of major restructurings including Playdium, Consumers Packaging, PSI Net, Cotton Ginny, Iwrin Toy, Air Canada and JTI Macdonald. He has also been involved in several large lender liability disputes.

Financial Services Litigation

Our Financial Services Litigation Group acts for both domestic and foreign financial institutions on a wide range of matters. We represent clients in collecting debts and enforcing security, including guarantees, priority claims, letters of credit and other financial instruments. We also handle *Bills of Exchange Act*, fraud and fraudulent conveyance, and auditors' negligence litigation, and defend financial institutions in class actions and in claims against them for breach of fiduciary duty, lender liability, breach of contract and breach of trust. We enhance our clients' representation by calling upon the broad expertise of our lending and insolvency solicitors as needed.

For more information please contact your McMillan Binch lawyer or one of the members of the

Financial Services Litigation Group listed below:

Lisa Brost	416.865.7186	lisa.brost@mcmillanbinch.com
Hilary E. Clarke	416.865.7286	hilary.clarke@mcmillanbinch.com
Jeffrey B. Gollob	416.865.7206	jeff.gollob@mcmillanbinch.com
Brett G. Harrison	416.865.7932	brett.harrison@mcmillanbinch.com
Andrew J. F. Kent	416.865.7160	andrew.kent@mcmillanbinch.com
Lisa H. Kerbel Caplan	416.865.7803	lisa.kerbel.caplan@mcmillanbinch.com
Daniel V. MacDonald	416.865.7169	daniel.macdonald@mcmillanbinch.com
Paul G. Macdonald	416.865.7167	paul.macdonald@mcmillanbinch.com
Alex L. MacFarlane	416.865.7879	alex.macfarlane@mcmillanbinch.com
Jason Murphy	416.865.7887	jason.murphy@mcmillanbinch.com
Lisa Parliament	416.865.7801	lisa.parliament@mcmillanbinch.com
Leonard Ricchetti	416.865.7159	leonard.ricchetti@mcmillanbinch.com