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It s Not Just the Exchange Rate or the Spelling

The Substantial Differences Between Canada and the US in Handling Cheque (Check) Fraud Claims Implications for Insurers

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I. Introduction

In Canada, check is spelled cheque ; and cheques are, of course, generally written in Canadian dollars and drawn on Canadian banks.

Those are not, however, the only differences between Canadian and US law and banking practices relating to cheques. There are several key substantive differences between Canadian and US law of cheques, particularly the law relating to forgeries on cheques. Insurers need to be aware of these differences in writing policies, underwriting risk, and evaluating claims.

II. Canada s cheque clearing system

A cheque is simply a kind of bill of exchange that is drawn on a bank.[1] Cheques are thus governed by the *Bills of Exchange Act*. In addition, the process by which cheques are cleared and settled between banks is provided for in the rules of the Canadian Payments Association.

The *Bills of Exchange Act* and the Canadian Payments Association are discussed briefly below.

1. Bills of Exchange Act

Bills of exchange have been used for hundreds of years to facilitate commerce. In an era before electronic funds transfers, bills of exchange provided a simple and effective way to provide for payment of a debt in a far away place, or to provide for the repayment of borrowed money.

The *Bills of Exchange Act* is a codification of the common law of bills of exchange. The United Kingdom passed its *Bills of Exchange Act* in 1882, and Canada

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[1] Bills of Exchange Act, *R.S.C. 1985, c. B-4, s. 165 (Can.).*

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followed suit with very similar legislation in 1889.[2] The Canadian act has been little amended since. Though the language of the *Bills of Exchange Act* is more reminiscent of Trollope and Gallsworthy than of modern commerce, and though Canadians have embraced electronic payment systems, bills of exchange continue to be used in local and international commerce. In particular, millions of cheques are still written every day.

(a) What is a bill of exchange?

A bill of exchange is basically an instruction from one person, called the **drawer,** to another person, called the **drawee**, to pay money to yet another person, called the **payee**. More formally, a bill of exchange is:

- An unconditional order in writing
- From the **drawer**[3]
- To the **drawee**
- Requiring the drawee to pay a certain amount of money
- To or to the order of a specified person (the **payee**) or to bearer
- On demand or at a fixed or determinable future time.[4]

Bills of exchange can take many different forms with different functions. Perhaps the best known and most common kind of bill of exchange is a **cheque.** A cheque is a bill that is drawn on a bank and is payable on demand.[5]

(b) Negotiability

Negotiability is a hallmark of a bill of exchange.[6] Negotiability adds to the utility of bills of exchange. For instance, it allows a creditor to discount a promissory note[7] and get money immediately. It also allows consumers to cash cheques at institutions other than banks, such as grocery stores (at one time a common practice in Canada).

Negotiation means a transfer of the bill from one person to another in such a way as to make the person receiving the bill the **holder** of the bill.[8] In other words, negotiation transfers title in the bill from one person to another.

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[2] *For a discussion of the history of the law merchant , the common law relating to bills of exchange, and the* Bills of Exchange Act, *see Crawford and Falconbridge,* Banking and Bills of Exchange, *8th ed. 1986, §4701-4704. The common law and law merchant (a branch of the common law) continue to apply to bills of exchange:* Bills of Exchange Act, *s. 9.*

[3] *In the case of a corporate drawer, the drawer is the entity drawing the bill (i.e., out of whose bank account the cheque is drawn, or who is incurring liability) and not the person who writes out and signs the cheque.* Boma Mfg. Ltd. v. Canadian Imperial Bank of Commerce *(1996), 140 D.L.R. (4th) 463, 484 (S.C.C.).*

[4] Bills of Exchange Act, *s. 16.*

[5] Bills of Exchange Act, *s. 164.*

[6] *A bill containing words preventing its negotiation, however, is valid.* Bills of Exchange Act, *s. 20.*

[7] *Although promissory notes are not bills of exchange, they are governed by the* Bills of Exchange Act.

[8] Bills of Exchange Act, *s. 59(1).*

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There are two ways a bill can be negotiated, depending on the kind of bill. A bill payable to bearer can be negotiated by **delivery** without anything more.[9] Delivery is defined as a transfer of possession from one person to another.

A bill payable to order that is, to a particular person must be negotiated by **endorsement**.[10] An endorsement must be written on the bill and signed by the endorser.[11] In practice, a payee of a cheque usually just signs the back of the cheque at the bank counter. But the endorser can add words specifying the person to whom the bill is being transferred, such as pay to *x* or pay to the order of *x*.[12] The person named in the endorsement *x* is treated like a payee.[13] If no words are added specifying a new payee, then the endorsed bill or cheque becomes payable to bearer.[14] The person to whom the bill or cheque is transferred through negotiation becomes a **holder in due course**[15] of the bill.

When a bill is endorsed as payable to a new payee, that new payee can negotiate the bill to yet another person by endorsing it, and so on. However, bills can be endorsed with a restriction on further negotiation, for instance, by writing Pay *x* only.[16] In addition, some businesses stamp cheques For deposit only to the account of *x*.[17]

(c) Liability of parties to a bill

Another hallmark of a bill of exchange is the liability of the various parties. Ultimately, a bill will be presented to the drawee for payment. If the drawee pays it, the bill is discharged and cancelled and that is the end of the matter. But the drawee has no liability to the payee or any other holder to pay the bill. (The drawee may, of course, have an obligation to the drawer to honour the bill if funds are available on deposit.)

If the drawee **dishonours** the bill that is, refuses to pay it a number of provisions fix liabilities upon the parties to the bill. The drawer is liable due to the fact that, in drawing the bill, the drawer engages that on presentment the bill will be paid.[18] Any endorsers are also liable because, by endorsing the bill, they made the same engagement: that the bill will be paid.[19] In addition, an endorser guarantees all previous endorsements.[20]

The liability of parties to a bill makes bills more useful in commerce because in the event a bill is dishonoured, the holder can sue any prior endorsers or the drawer on the bill itself.[21] The holder s right to payment cannot be frustrated by defences that

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[9] Bills of Exchange Act, *s. 59(2). Delivery is defined in s. 2 as a transfer of possession from one person to another.*
[10] Bills of Exchange Act, *s. 59(3).*
[11] Bills of Exchange Act, *s. 61(1).*
[12] Bills of Exchange Act, *s. 66. A signature without anything more is called an endorsement in blank; a signature plus words specifying a new payee is called an endorsement in special.*
[13] Bills of Exchange Act, *s. 66(4).*
[14] Bills of Exchange Act, *s. 66(2).*
[15] Bills of Exchange Act, *ss. 55-57.*
[16] Bills of Exchange Act, *s. 67.*
[17] *Technically, such a stamp is not an endorsement under the Act.* Boma, *140 D.L.R. (4th) at 489.*
[18] Bills of Exchange Act, *s. 129.*
[19] Bills of Exchange Act, *s. 132.*
[20] Bills of Exchange Act, *s. 132.*
[21] Bills of Exchange Act, *s. 134.*

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might be available to the drawer in respect of the contract that gave rise to the bill in the first place, as it would be if the holder had taken an assignment of that contract.[22]

In the case of a cheque, the drawer will typically draw the cheque to the order of the payee on a pre-printed cheque form.[23] Typically, the payee of a cheque will cash it at his or her bank (called the collecting bank), which will collect the cheque by presenting it to the drawee bank for payment. If there is money in the drawer s account, the drawee bank will pay it and the cheque will be cancelled. If there are insufficient funds in the drawer s account the cheque will be dishonoured. If the cheque is dishonoured, it is returned to the collecting bank. The collecting bank exercises its recourse against the payee by debiting the payee s account. The payee then has a recourse against the drawer.

(d) Negotiability makes bills vulnerable to fraud

While negotiability of bills of exchange adds to their usefulness in commerce, it makes them more vulnerable to fraud. A rogue can intercept a bill, endorse it with the name of the payee, obtain value for the bill, and disappear before the fraud is discovered. The person who accepted the bill from the rogue, usually the collecting bank, usually suffers the loss.[24] The consequences of fraud on a bill are discussed in more detail below.

The *Bills of Exchange Act* contains special provisions that allow holders of a cheque to reduce its negotiability by crossing it. A crossed cheque can only be deposited into a bank, or, if crossed to a particular bank, into that bank. Certain provisions protect a bank that collects a crossed cheque from liability. Although the practice of crossing cheques would help prevent cheque fraud, it is unheard of in Canada a teller presented with a crossed cheque for deposit would probably not know what to do with it![25]

2. Canadian Payments Association

The Canadian Payments Association (CPA) operates a system for clearing and settling payment items, including cheques, between banks in Canada. The CPA is established under the *Canadian Payments Act*.[26] All banks in Canada are automatically members of the CPA.

The CPA supplements the *Bills of Exchange Act* by providing a facility for collecting banks to present cheques for payment to drawee banks, and to receive payment from the drawee bank.

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[22] *Crawford and Falconbridge,* Banking and Bills of Exchange*, 8th ed., 1986, § 5302.9*
[23] *The use of pre-printed cheques is not in fact mandatory as far as the* Bills of Exchange Act *is concerned.*
[24] *Rules relating to forged endorsements and signatures are discussed in Section III,* infra.
[25] Bills of Exchange Act*, s. 164-175. By contrast, in the UK, cheque blanks are usually already crossed. More recently, an amendment to the UK* Bills of Exchange Act 1882 *provided for crossing cheques and writing account payee . Such a cheque is not negotiable but is only valid between the parties. The payee must deposit it into his or her bank account and cannot cash it through a non-bank third party. See* Cheques Act 1992*, 1992 c. 32.*
[26] Canadian Payments Act*, R.S.C. 1990, c. C-21 (Can.).*

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The CPA also provides a facility for banks to exercise some of the recourses found in the *Bills of Exchange Act* against one another without the need for legal proceedings. A drawee bank can, for instance, return an item through the clearing to the collecting bank pursuant to rules that, with some exceptions, mimic the rights found in the *Bills of Exchange Act*. This process is called reverse clearing .

Cheques and other payment items clear very quickly in Canada thanks to the CPA s Automated Clearing Settlement System . Cheques are typically cleared overnight in regional data centres on the same day they are deposited, and usually arrive at the drawer s bank branch the next day. It is dangerous in Canada to write a cheque one day and deposit money the next to cover it.

Under the CPA system, banks do not pay individual cheques when they are presented. Rather, every day all of the cheques and other payment items are added up, and the flows between banks are netted out using settlement accounts at the Bank of Canada.

The Automated Clearing Settlement System (ACSS) handles an average of 17 million payment items every day, of which three quarters are electronic transactions, and the remainder, paper-based transactions.[27]

Although all banks are members of the CPA, only 11 financial institutions have direct access to ACSS as direct clearers . Other financial institutions, known as indirect clearers , can access ACSS through an account with a direct clearer.

The CPA s various systems are governed through extensive rules; it is, however, beyond the scope of this paper to attempt to summarize them. Certain CPA rules relating to reverse clearing will be discussed in the section Reverse clearing under CPA Rules below.

The CPA is in the process of developing a system for imaging and clearing cheques electronically called Truncation and Electronic Cheque Presentment. The CPA plans to implement this new system in 2006. Implementation of such a system will certainly require amendments to the *Bills of Exchange Act*. Among the advantages the CPA claims for cheque imaging is reduced cheque fraud because of increased speed.

The speed of the Canadian cheque clearing system compares favourably to that of the UK and the US. Like Canada, the UK has a single, centralized clearing system. Cheques in the UK are cleared and settled through the Cheque and Clearing Company. This system operates on a three day cycle. Payments are settled through accounts at the Bank of England. The Cheque and Clearing Company has 12 full members (ie, direct clearers); other financial institutions must use a full member as a clearing agent.

In contrast, the US does not have a single, centralized clearing and settlement system. Rather, cheques are cleared and settled either directly between banks, through the Federal Reserve, or through clearinghouse exchanges. Still, cheques clear quite quickly. The Check 21 Act will speed up the cheque clearing process dramatically in the

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[27] *However, paper-based transactions accounted for nearly three quarters of the total value cleared through ACSS. The CPA also operates two other systems: the Large Value Transfer System (LVTS), for irrevocable, real-time electronic funds transfers, and the US Dollar Bulk Exchange, for payment items in US dollars. In 2003, LVTS cleared over $31.5 trillion in transfers, accounting for 88% of the value flowing through the CPA system.*

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US because it allows cheques to be scanned and converted into electronic payment items.

Apart from convenience, speedy cheque clearing can assist in reducing cheque fraud. Forgeries can be detected more quickly and money recovered.[28] Additionally, cheque kiting schemes become much more difficult in an environment where cheques clear within a day or two.

III. Return of cheques with forged or unauthorized signatures or endorsements

1. Action to recover monies paid on a forged endorsement or signature

(a) *Bills of Exchange Act* sections 48 and 49

The *Bills of Exchange Act* contains two important provisions dealing with forged signatures and endorsements. Because an endorsement typically includes a signature, a forged endorsement is generally also a forged signature.

Section 48 deals with forged or unauthorized signatures generally (including endorsements)[29] and provides that:

A forged or unauthorized signature is wholly inoperative .

A forged or unauthorized signature cannot create a right to retain the bill, give discharge for the bill, or enforce payment of the bill unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery or want of authority (this defence will be discussed in more detail below).

In the case of a forged endorsement on a cheque, there is a one year limitation period for the drawer to notify the drawee (bank) of the forgery. However, this one year period starts to run only upon the drawer discovering the forgery. After one year, the cheque is deemed to have been paid in due course with respect to every party that has not commenced proceedings.

Section 49 provides that anyone who has paid out in good faith on a bill bearing a forged or unauthorized endorsement can recover the money from any endorser who has endorsed the bill after the forged endorsement. Additionally, anyone from whom this person recovers has a similar right of recovery against people who endorsed before this person, but after the forgery.

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[28] *For instance, in* Bank of Nova Scotia v. Toronto-Dominion Bank, *[2001] O.J. No. 1717 (C.A.), the drawer learned that a forged check had been drawn on its account the day after the cheque was issued. The banks were notified immediately and they were able to recover just under half of the amount stolen by freezing the accounts of the forger.*
[29] *In banking practice, the term forged signature usually means a forgery of the signature of the drawer; and forged endorsement , a forgery of the signature of the endorser. Both are forged signatures within the meaning of the* Bills of Exchange Act.

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This provision is related to the liabilities provided for in section 132. By accepting a bill or cheque from someone and then endorsing it over to another in exchange for value, the endorser is guaranteeing all prior endorsements. Effectively, the endorser is guaranteeing that he or she has good title in the bill. What the *Bills of Exchange Act* does, in other words, is to set up a cascading series of duties and corresponding liabilities to make sure that the person trying to cash a cheque or sell a bill has the right to the cheque or bill in the first place.

While section 49 appears on its face to create a statutory cause of action, the recourse it speaks of is generally exercised through an action for conversion, and occasionally, monies had and received.[30]

The respective liabilities of the collecting and the drawee banks is discussed below. The general rule can be summarized simply as follows: subject to any defences such as preclusion, the drawee bank is liable for any forgery on the front of the cheque (i.e., forgery of the signature of the drawer); and the collecting bank is liable to any forgery on the back of the cheque (i.e., a forged endorsement).

(b) Liability of collecting bank for conversion of cheques

Where a collecting bank pays out on a forged endorsement, the collecting bank will be liable for conversion to the owner of the cheque or bill.[31]

The tort of conversion occurs when someone takes or retains personal property (a chattel) belonging to someone else in a manner inconsistent with that person s continued ownership of it.[32] The remedy for conversion is payment of the full value of the property.

Since cheques and other bills of exchange are chattels, an action in conversion can lie when they are dealt with fraudulently. The value of the cheque or other bill is considered to be its face value, rather than the value of the paper and ink.[33]

The person who seeks to sue must have a right to immediate possession of the bill. In other words, it is the current true owner of the bill who can sue.[34] Depending on

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[30] *This is the case in the common law jurisdictions of Canada, which are all of Canada except Quebec. Private law in Quebec, including tort law, is governed by the* Civil Code of Quebec*, and forged cheque cases there tend to be based causes of action in the* Civil Code *rather than conversion. However, s. 9 of the* Bills of Exchange Act *says that the common law of England, including the law merchant, applies to bills, notes and cheques. Crawford and Falconbridge argue that the common law thus applies to an action on a bill of exchange in Quebec. Crawford and Falconbridge, § 5003.6. At one time, an action for monies had and received had certain advantages. This is not the case today. For a discussion of the action for monies had and received, see* id.*, § 5003.6(d).*

[31] Boma, *140 D.L.R. (4th) at 478.*

[32] Id.; Westboro Flooring and Decor Inc. v. Bank of Nova Scotia, *[2004] O.J. No. 2464 (C.A.).*

[33] Number 10 Mgmt. Ltd. v. Royal Bank of Canada *(1976), 69 D.L.R. (3d) 99, 108 (Man. C.A.); Crawford and Falconbridge,* Banking and Bills of Exchange*, 8th ed., 1986, § 5003.6.*

[34] Boma*, 140 D.L.R. (4th) at 478. For instance, if a cheque has already been given to the payee, the drawer no longer has a right to possession of it and the payee does. If, however, the cheque is not created in respect of legitimate debts, then the payee does not have any right to possession. The latter of these two propositions is somewhat troubling. One of the advantages of bills of exchange is to create a device for transferring money that is independent of the underlying transaction. But* Boma *appears to suggest that by impugning the underlying transaction, any bills of exchange used to pay an obligation relating to the transaction might similarly be impugned by way of an action for conversion. As between the parties to the*

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the circumstances, this may be the drawer, the payee, or a holder to whom the bill has been endorsed.

Conversion is both an intentional tort and a strict liability tort in two senses. First, it is an intentional tort because the person converting the property must have intended to take it up as his or her own. However, no wrongful intention or negligence is required to impose liability. A person can convert property in all innocence and still be liable. Second, no defence of contributory negligence is available.[35]

This is a harsh doctrine. It effectively pins liability for forged endorsements on the collecting bank. The policy behind making the collecting bank liable appears to be that the collecting bank is theoretically in the best position to detect the forged endorsement. Pigeon J. said, in *Concrete Column Clamps (1961) Ltd. v. Royal Bank of Canada*:

> By making banks responsible for cheques cashed on a false endorsement, our Bills of Exchange Act certainly has the effect of making it more difficult to cash a cheque fraudulently.[36]

In *Boma*, Iacobucci J. commented:

> However, the likelihood of fraud is dramatically higher when a person presents a third party cheque, particularly when it bears no endorsement. A collecting bank is not permitted to assume that the transaction is genuine in the face of circumstances that are so clearly prone to fraud. This is why the collecting bank is required, in the case of third party cheques, to ensure that they have been endorsed.[37]

(c) Liability of drawee bank for forged signature

(i) Drawee bank should refuse to pay

If the drawer s signature is forged or unauthorized, it follows that there is no valid order to the bank from the drawer to pay the amount of the cheque. In the absence of such an order, the bank has a contractual duty to its customer, the drawer, not to pay money out of the drawer s account.

The drawee bank is expected to know its customer s signature and verify that the drawer s signature on the cheque matches the drawer s signature in the bank s records. If the signatures do not match, the payment should be refused and the cheque returned dishonoured.

The practical effect of returning the cheque is that the collecting bank may have to bear the loss, depending on its arrangements with its customer.

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transaction, this does not raise any difficulty, but if other holders of the bill could be sued in conversion, then this would seriously undermine the utility of bills of exchange.

[35] Boma, *140 D.L.R. (4th) at 475-477.*

[36] Concrete Column Clamps (1961) Ltd. v. Royal Bank of Canada, *[1977] 2 S.C.R. 456, 484.*

[37] Boma, *140 D.L.R. (4th) at 490.*

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In practice, of course, banks do not have time to compare the signatures on every one of the millions of cheques they process every day to their signature cards. If a signature of a drawer turns out to be forged, the drawee bank stands a good chance of suffering the loss, as discussed below.

(ii) Drawee is liable to drawer

The drawee bank will be liable to the drawer if it debits the drawer s account after paying out on a cheque with a forged signature.[38]

The liability of the drawee bank to its customer is almost always limited by a verification clause in the banking agreement requiring the drawer to verify all transactions within 30 days (or some other period), after which all transactions are deemed correct. After the expiry of the verification period, the drawer will not be able to recover money paid on a cheque with a forged signature from its bank (or, as discussed below, the collecting bank). Courts will not, however, impose a duty on the customer (drawer) to verify transactions absent a contractual duty.[39]

(iii) Collecting bank is not liable to drawer

Drawers that miss the verification period and cannot sue the drawee bank have attempted to recover from the collecting bank instead. However, the collecting bank is not liable to the drawer when the drawer s signature on the cheque is forged. One consequence of the statement in section 49 of the *Bills of Exchange Act,* that forged signatures are wholly inoperative , is that where the signature of the drawer is forged or unauthorized, the purported bill is not a bill of exchange at all. It is not a valuable instrument.[40] This means that there is nothing to convert, except perhaps the value of the paper.

Since there is no valuable instrument to convert, the collecting bank cannot be liable for conversion. The collecting bank is also not liable to the drawer for monies had and received, because (i) the money received by the collecting bank is not, technically, the drawer s money but the drawee bank s money; and (ii) monies are not received for the benefit of the collecting bank, but rather for the benefit of the person cashing the cheque.[41]

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[38] Arrow Transfer Co., *(1972), 27 D.L.R. (3d) 81 (S.C.C.) 84-85;* Number 10 Mgmt., *69 D.L.R. (3d) at 104. There is also authority for the proposition that the drawee bank s liability is in debt.* Exceptional Resources Inc. v. Alberta (Treasury Branches), *[2001] A.J. No. 1114 (Alta. Prov. Ct.).*

[39] CP Hotels Ltd. v. Bank of Montreal, *(1987) 40 D.L.R. (4th) 385 (S.C.C.)*

[40] Arrow Transfer Co. v. Royal Bank of Canada*; 27 D.L.R. (3d) at 87-88;* Number 10 Mgmt., *69 D.L.R. (3d) at 105-106.*

[41] Arrow Transfer Co., *27 D.L.R. (3d) at 87;* Number 10 Mgmt., *69 D.L.R. (3d) at 105. This latter point is inconsistent with cases fixing liability on collecting banks for monies had and received when they pay out on a cheque with a forged endorsement; here also, the collecting bank does not receive the money to its benefit, but to the benefit of the person cashing the cheque.*

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(iv) Collecting bank is not liable to drawee bank

If the drawer recovers from the drawee bank, the drawee bank generally will bear the liability. The collecting bank is not liable to the drawee bank, for a number of reasons.[42] These include the fact that the drawee bank is expected to know and verify the signature of its customer (the drawer) or take the risk, just as the collecting bank is expected to verify the endorsement or take the risk. By paying the cheque, the drawee bank is representing that the drawer s signature is genuine.

2. Defences and particular issues

(a) Notice requirements and limitation period

The *Bills of Exchange Act* contains two notice provisions that apply to forged endorsements and effectively establish limitation periods.

Before a *drawer* can bring an action in respect of a forged endorsement against the drawee, the drawer must notify the drawee within **one year** after the drawer aquires notice of the forgery.[43] If the drawer fails to do this, the cheque is conclusively presumed to have been paid in due course.[44]

Before the *drawee* (and anyone who pays on behalf of the drawee) can claim against a prior endorser, it must give notice to that endorser within a reasonable time after acquiring notice that the endorsement is forged or unauthorized.[45] The cases suggest that a reasonable time will be relatively short waiting for months likely will not be reasonable.[46] This is because one of the purposes of notice is to enable steps to be taken to recover the money from the forger. Since the same cause of action lies against all endorsers, notice should be given to all of them.

What constitutes notice of the forgery can be problematic. Actual knowledge clearly suffices, while constructive knowledge is not enough, but wilful blindness probably is.[47] A recent case, however, suggests that knowledge of where the money ended up, even without knowledge of the forgery, may amount to notice of the forgery.[48]

(b) Fictitious or non-existing payee defence section 20(5)

Section 20(5) of the *Bills of Exchange Act* says that if the payee is fictitious or non-existent, the bill or cheque is payable to the bearer. This means that the bill or cheque can be negotiated by delivery; no endorsement is needed. As a result, it does

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[42] *See Crawford and Falconbridge, § 5003.6(g).*
[43] Bills of Exchange Act, *s. 48(3);* Bank of Montreal v Quebec (Attorney General), *[1979] 1 S.C.R. 565.*
[44] Bills of Exchange Act, *s. 48(4).*
[45] Bills of Exchange Act, *s. 49.*
[46] *See Crawford and Falconbridge, § 5003.6(g).*
[47] Price Meats Ltd. v. Barclays Bank plc, *[1999] E.W.J. No. 6470 (H.C.J.), citing Devlin J. s statement in* Roper v. Taylors Central Garages (Exeter) Ltd, *[1951] 2 T.L.R. 284, 288-89 (Divisional Court) (The case of shutting the eyes is actual knowledge in the eyes of the law).*
[48] Nasrin Karim Professional Corp. v. Bank of Nova Scotia, *[2004] A.J. No. 607.*

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not matter if there are forged endorsements on the back of the cheque. Where section 20(5) applies, it provides a complete defence to an action for conversion (or any other action to recover monies paid out on the cheque).

What constitutes a fictitious or non-existent payee has spawned a great deal of litigation. The difficulty is that the intention of the drawer is highly relevant to determining whether the payee is fictitious. It should be noted that where the drawer is a company, it is the intention of the company that is relevant, not the intention of the person actually preparing the cheque.[49]

Obviously, if the drawer simply makes up a payee, or names someone who is dead, then the payee is fictitious or non-existent. The difficult cases are where the payee is a real person. If the payee is a real person, but the drawer had no intention of paying any money to that person, then the payee is fictitious and the cheque is payable to bearer.

However, if the drawer is a company and it believes that cheques are made out for an existing obligation to an existing person known to the company, the payee is not fictitious, and the cheque is payable to order, not to bearer.[50] Where dishonest employees prepare cheques to themselves or their family members (as occurred in *Boma*), the intention of the employee will not generally express the intention of the company. There is a presumption that companies intend that the cheques will be paid to a real person on account of an existing obligation. Consequently, such cheques will be payable to order.

(c) Preclusion defence

Section 48(1) of the *Bills of Exchange Act* reads 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 to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under that signature, <u>unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery or want of authority</u>. (emphasis added)

The words underlined above create a defence of "preclusion". The word "preclusion" was chosen in the British statute instead of "estoppel" because "estoppel" is unknown in Scottish law. The same word was chosen in the Canadian statute because "estoppel" was unknown in the civil law of Quebec.[51]

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[49] Boma, *140 D.L.R. (4th) at 485.*
[50] Id. *at 486;* Westboro Flooring and Decor Inc. v. Bank of Nova Scotia, *[2004] O.J. No. 2464 (C.A.) at 25.*
[51] *Crawford and Falconbridge, § 5003.4*

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The way the defence of preclusion operates is to prevent a party from setting up or relying on the forgery either as a defence or as an element of the tort of conversion or other cause of action. As a result, the defence of preclusion is a complete defence.[52]

The ambit of the defence of preclusion has yet to be precisely defined. It clearly includes estoppel, including an estoppel by silence when there is a duty to speak.

Preclusion also includes at least some forms of negligence. In *Nesbitt Burns Inc. v. Canada Trustco Mortgage*,[53] the Ontario Court of Appeal suggested that only the conduct of the drawer is relevant to the defence of preclusion by negligence. The court also pointed out that, as between the drawee bank and its customer, only negligence in the transaction by the drawer may preclude the drawer from setting up the forgery. As an example, the court cited the case of a drawer who signs a cheque in blank or leaves spaces that allow another to raise the cheque.

The court s reasoning in *Nesbitt Burns* is unsatisfactory. First, section 48 is not limited to the drawer; it contemplates that any party to the bill might be precluded. Second, it can be argued that limiting the defence to the conduct of the drawer would limit it to cases where the signature of the drawer is forged. In our view, however, this is inconsistent with section 48, which applies to both forged endorsements and forged signatures of the drawer. Indeed, the court did not foreclose the argument that negligence in the transaction by the drawer that facilitates the placing of a forged endorsement on the cheque precludes the drawer from setting up the forged endorsement. Third, the examples given by the court are not really examples of the defence of preclusion under section 48 (even though the cases tend to discuss them in terms of preclusion) because they do not involve forged signatures.[54]

One thing is clear however: a defence of contributory negligence leading to an apportionment of liability is not available in an action for conversion of a cheque with a forged endorsement. This is because conversion is a strict liability tort.[55]

(d) Blank cheques

If a drawer of a cheque signs a bill in blank, the holder of the cheque can fill in any amount, or any missing information, in any way he or she pleases.[56] The holder is supposed to complete the bill as directed by the drawer, but if he or she does not, the drawer will be precluded from denying the validity of the bill against any party other than that person.[57]

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[52] Nesbitt Burns Inc. v. Canada Trustco Mortgage, *[2000] O.J. No. 868 (C.A.)*.
[53] *[2000] O.J. No. 868 (C.A.)*.
[54] *Our colleague Ken Dekker argued this case for the drawer and, needless to say, disagrees with much of our criticism of this decision!*
[55] Boma, *140 D.L.R. (4th) at 475-477*.
[56] Bills of Exchange Act, *s. 30*.
[57] Bills of Exchange Act, *s. 31;* Canadian Imperial Bank of Commerce v. Lowenberg, *[2003] S.J. No. 198*.

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(e) Delivery to deposit of payee section 165(3)

Section 165(3) of the *Bills of Exchange Act* states:

> 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 of the cheque.

Before *Boma*, the meaning of this provision was much debated. It was enacted in response to uncertainty about whether a collecting bank was considered to be a holder in due course like any other endorser of a cheque. The jurisprudence before section 165(3) focused on whether the bank had truly advanced money in exchange for the cheque.[58] On its face, section 165(3) would apply whenever a bank deposits a cheque for a client, even if the cheque was payable to a third party.

In *Boma*, the Supreme Court of Canada severely restricted the availability of section 165(3), holding that it only applies when the bank deposits a cheque to the credit of the account of the *payee*. This reading of section 165(3) effectively nullifies it, since a cheque deposited by the payee to the account of the payee will never have a forged endorsement.[59]

3. Reverse clearing under CPA Rules

The CPA Rules provide a mechanism for a drawee bank to return an item to the collecting bank and be refunded any money paid on the item.[60] This is called reverse clearing . A drawee bank does not have to use the CPA reverse clearing process and can return an item outside of the system or sue the collecting bank; but the CPA system provides an expedient way to recover funds paid out on a cheque bearing a forged endorsement.

The *Bills of Exchange Act* overrides the CPA rules. Consequently, the CPA Rules do not take away any of the defences discussed above.[61]

Rule A4 s. 4 provides that the drawee can return the item if for any reason payment is refused or cannot be obtained. The rule thus applies to all of the various reasons a cheque might be returned, including forged endorsements or forged signatures of the drawer.

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[58] *Section 57 of the* Bills of Exchange Act *presumes that every holder of a bill obtained it for value and is a holder in due course.*

[59] *We doubt the correctness of* Boma *on this point. The Supreme Court in* Boma *appears to have assumed that a holder in due course takes free from a defect arising from a forged endorsement. Holders in due course receive certain limited protections under the* Bills of Exchange Act. *In particular, their title to the bill is not affected by defects in title of prior parties. However, being a holder in due course does not provide a defence to an action for conversion where the endorsement is forged. Crawford and Falconbridge, § 5302.3.* Bills of Exchange Act *s. 55(2) limits the kinds of defects in title that do not affect a holder in due course; forged endorsements are not among them. In any event, on either reading, the protection offered by s. 165(3) is very narrow and never applicable to save a collecting bank from liability for a forged endorsement.*

[60] *CPA Rule A4 Returned and Redirected Items*

[61] Bank of Nova Scotia v. Toronto-Dominion Bank, *[2001] O.J. No. 1717 (C.A.).*

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The rule imposes a short time limit on most returns. Once the item reaches the organizational unit within the drawee that can decide whether to honour or dishonour the item, the drawee has one day to return the item.[62] This time limit *does* apply to a forged signature the drawee is expected to know the signature of its customer and compare it as part of the decision whether to honour the item, but it *does not* apply to forged endorsements. There is no time limit on the return of forged endorsements under the CPA rules.[63] If both the endorsement and the drawer s signature are forged, the one day limit applies.[64]

Any item reverse cleared on account of a forged endorsement must be accompanied by a declaration by the purported endorser declaring that the endorsement is forged and not authorized and stating when the purported endorser became aware of the forgery.[65] Once an item hase been reverse cleared, it generally cannot be cleared again unless the drawee agrees.[66]

The CPA rules also deal with missing or incomplete endorsements. Basically, the drawee bank must first demand that the collecting bank provide any missing endorsements. If the collecting bank cannot do so, it must reimburse the drawee bank.[67]

The CPA rules allow the collecting bank to dispute the return of an item. The rule contemplates that the banks will attempt to resolve the dispute between themselves, and that if they cannot, a dispute resolution panel will do so.[68]

IV. Implications for the fidelity insurance industry

The differences between Canadian and US law on bills of exchange and banking practices generally, and forged signatures and endorsements in particular, have obvious implications for the fidelity insurance industry.

Policies and underwriting practices in the insurance industry tend to be based on US law. When these policies are used in the Canadian market, there is a risk that disconnects between policy language and Canadian law could lead to unpredictable results for both the insurer and the insured. The policy might respond where the insurer thought it would not; or not respond where the insured thought it would. Similarly, differences in the extent of liability in Canada could lead to inappropriately high or low premiums as a result of assessing risks based on US law.

These differences do not merely present risks; they also present opportunities. Insurers that take the trouble to make their policies fit with the legislation in different markets may be able to offer a more attractive product.

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[62] *Rule A4 s. 5.*
[63] *Rule A4 s. 6(a).*
[64] *Rule A4 s. 7(b).*
[65] *Rule A4 s. 16.*
[66] *Rule A4 s. 8.*
[67] *Rule A4 s. 15.*
[68] *Rule A6.*

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A few examples of divergences between a US standard form, Standard Form No. 24, Financial Institution Bond, and Canadian law are briefly mentioned below.

1. Forgery

Forgery is defined in Form 24 as:

the signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one s own name signed with or without authority, in any capacity, for any purpose.

The *Bills of Exchange Act* also extends to *unauthorized* endorsements. Consequently, the coverage offered by Form 24 may be less than the potential liability of banks under Canadian law.

2. Negotiable instrument

The definition of negotiable instrument in Form 24 contains the proviso that a negotiable instrument contain no other promise, order, obligation or power given by the maker or drawer than the unconditional promise to pay.

The *Bills of Exchange Act* does not contain any such express limitation. Moreover, the *Bills of Exchange Act* allows the drawer and holders of a bill to add various restrictions to it.

It is possible that a document could qualify as a bill of exchange under the *Bills of Exchange Ac*, but not be a negotiable instrument for purposes of Form 24. In that case, a bank s potential liability would be broader than its coverage.

3. Exclusion o

Exclusion o excludes loss resulting from payments made or withdrawals from a depositor s account involving items of deposit which are <u>not finally paid for any reason</u>, including but not limited to Forgery or any other fraud

It is at least arguable that cheques in Canada are *never* finally paid. Payment of a cheque can be reversed many years after it is drawn if a forged endorsement is discovered on it.

About the authors

Peter Greene is a founding partner of Affleck Greene Orr LLP. He practises commercial litigation, with an emphasis on surety, fidelity and dishonesty bond claims, banking and securities litigation.

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