

BANKER AND CUSTOMER REVISITED

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The purpose of this article is to re-examine recent Canadian cases on the relationship between banker and customer, and to a lesser extent between banker and third party. The paper focuses on the contractual and tortious issues which arise in the context of the operation of banking accounts, and argues that in recent years the courts have appeared to be more willing to import broader duties and standards of care into these relationships than in the past. In so doing the courts may well be compensating for the banks' use of their superior bargaining power as evidenced in their standard form contracts, and as well may also be bringing the banker and customer contract into the emerging law of obligations.

L'auteur de cet article a pour but de réexaminer les récentes causes canadiennes ayant trait aux rapports entre le banquier et son client et, en moindre détail, aux rapports entre le banquier et les tiers. Elle s'intéresse avant tout aux questions de droit des obligations et de droit délictuel que soulève le fonctionnement du compte en banque et avance que les tribunaux semblent s'être récemment montrés enclins à imposer des devoirs et des normes de prudence plus étendus que par le passé. Ce faisant, les tribunaux cherchent peut-être à compenser la position avantageuse qu'utilisent les banques dans leurs négociations, comme en témoignent leurs contrats types, et font aussi peut-être entrer le contrat entre banquier et client dans le domaine du droit naissant des obligations.

Introduction

For well over a century, it has been said that the banker and customer relationship is one of contract. Yet, despite the substantial volume of case law, the courts have not often been required to make searching explorations of the contractual ramifications of that assertion, so that the law-of banker and customer appears rudimentary in comparison to the other branches of the law of contract. Recently, however, there are indications in the case law that the banker and customer contract is being subjected to more rigorous contractual, as well as tortious analysis, and it is the purpose of this paper to examine those developments, and thereby to re-visit the banker and customer relationship. In the process, it will also be necessary to consider the impact of some of these developments on the position of a bank *vis-à-vis* third parties.

The contract in question is essentially that entered into when a customer opens an account with a bank, and the contractual package is comprised of the express terms, contained typically on the reverse side of the so-called "signature card" or in a bankbook or account verification

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agreement, and the terms implied by the common law. While "customer" has been defined as someone with an account or in such a relationship with a bank that opening an account may result,¹ it is clear that both account-owning customers and non-customers can, quite independently from the account nexus, enter into other legal relationships with banks, governed by their own legal rules. Common contractual examples include contracts for loans or of guarantee, letters of credit and foreign exchange transactions; while a tortious or fiduciary relationship may arise when banks give advice.² In addition, banks may also incur liability to third parties when dealing both with customers³ and non-customers⁴ in relation to both contracts and gratuitous services.⁵ This paper will focus on the contractual and tortious duties which arise as between banker and customer as well as banker and third party when a typical chequing account is opened and operated. In particular, it will examine several emerging trends in the case law over the past decade or so, which suggest that the courts may be willing to re-mold the banking contract to conform with current developments in contract and tort, especially the overlap and merging of these two branches of private law into an obligations law. This examination will proceed first by restatement of the most commonly used express terms and the implied terms traditionally found by the courts; secondly, by examination of several groups of cases involving the implication of a duty of inquiry or a general duty of care; and thirdly, by re-capitulation of the current state of the banker and customer contract with a view to future developments.

I. *The Contract*

At the outset, it is useful to restate first, the express terms commonly used in banking standard form contracts in Canada today and, secondly, the implied terms imported into the contract by the courts. The major Canadian banks⁶ use similar express terms in their banking standard form

¹ *Woods v. Martins Bank Ltd.*, [1959] 1 Q.B. 55 (Leeds Assizes), per Salmon J. at pp. 72-73. Cf. *Great Western Ry. Co. v. London and County Banking Co.*, [1901] A.C. 414 (H.L.). Duration in the relationship is not of the essence: *Commissioners of Taxation v. English, Scottish and Australian Bank Ltd.*, [1920] A.C. 683 (P.C.).

² See M.H. Ogilvie, *Banks, Advice-Giving and Fiduciary Obligation* (1985), 17 *Ottawa L. Rev.* 263, and the cases cited therein.

³ See, for example, *Thermo King Corp. v. Provincial Bank of Canada et al.* (1981), 130 D.L.R. (3d) 256 (Ont. C.A.), where a bank was found liable to the payee of a draft on the ground of inducing breach of contract; and *J. & F. Transport Ltd. et al. v. Markwart et al.* (1982), 136 D.L.R. (3d) 204 (Sask. Q.B.), where a bank was found liable to a customer's employer for negligently opening an account without inquiry.

⁴ *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*, [1964] A.C. 465 (H.L.)—of course!

⁵ *Ibid.*

⁶ I wish to thank the following banks for providing me with copies of their agreements currently in use: Bank of Montreal, Toronto-Dominion Bank, Royal Bank of Canada. The other Schedule "A" banks employ similar terms, as do the near-banks.

contracts, whether the account is opened by an individual customer, joint account holders, a sole proprietorship, a company, a partnership or an unincorporated association.⁷ A typical account agreement contains, *mutatis mutandis*, the following provisions.⁸ First, the customer waives presentment, notice of dishonour and protest of all instruments delivered to the bank in connection with any business of the customer, in the absence of special written instructions to the contrary, and agrees to assume liability in respect to such instruments. Secondly, the bank may employ and instruct in its sole discretion any agent to conduct any business of the customer, and that agent is deemed to be the agent of the customer who is solely responsible for the agent's acts and omissions, however caused. Thirdly, the customer agrees to indemnify the bank for a variety of losses, including instruments drawn on the account, instruments negotiated by the bank for which payment is not received by the bank, lost or stolen instruments, all claims of the customer against the drawees of all instruments delivered to the bank, the bank's costs and any claims made against the bank in relation to the customer's business, service charges and interest on overdrafts. Fourthly, in the event of an overdraft, the bank may act as it deems appropriate, including declining to honour cheques without notice or delay, and the customer promises to repay the overdraft on demand together with such interest or other charges that have accrued. Fifthly, the customer will draw encoded cheques only on the account for which the cheques are encoded, otherwise the bank will not be liable. Sixthly, the customer is obliged to examine the periodic statements of account and to give notice to the bank of errors or inaccuracies within a prescribed period, usually thirty days, from their deemed receipt; otherwise the statements are deemed to be accurate, except that the bank may re-open them and the customer is still obliged to report forged or unauthorized endorsements. Seventhly, the bank will forward all statements by ordinary mail to the customer's recorded address. The customer is obliged to advise the bank of non-receipt if the statement is not received within ten days of the date on which it is normally received, and the bank is not liable if the statements are not received. Eighthly, in the absence of special written instructions to the contrary, the executed agreement is applicable to all accounts with the bank, including those at other branches.

In addition to these terms, most agreements contain other terms unique to them. As well, deposit account agreements contain terms tailored to deposits such as notice requirements prior to withdrawal, and

⁷ In addition to the basic contract, there are, of course, additional agreements to be signed in relation to signing and borrowing, *inter alia*, which differ depending on the customer.

⁸ The following represents an attempt to state the basic provisions, common to all agreements. All agreements have additional provisions or provisions which may differ slightly from this summary.

joint account agreements contain terms relating to survivorship, signature and joint liability.⁹

In contrast to the usual express terms, which shift the risk of loss in the operation of a banking account to the customer, the terms implied into the contract at common law fade into insignificance. Indeed, the banking standard form contracts effectively negate the implied contractual terms.

The *locus classicus* for the contractual analysis of the banker and customer relationship is still the decision of the English Court of Appeal in *Joachimson v. Swiss Bank Corporation*.¹⁰ It built upon *Foley v. Hill*,¹¹ which had established that the fundamental nexus was one of debtor and creditor in that the customer's deposit is essentially a loan to the bank and held by the bank as a debtor and not in some fiduciary or trusteeship capacity.¹² The customer has no right to question the use made of the money by the banker since money deposited with the bank becomes the property of the bank, and the bank's main obligation is to repay an equivalent sum of money to the customer on his demand. Unlike other debtor and creditor relationships, in the banker and customer relationship it is the creditor who must seek out his debtor to demand repayment. If the debtor refuses to repay, then the customer's remedy is an action in debt.¹³

Broadly speaking, the common law traditionally has imported only four broad duties into the banking contract in relation to the banker's obligations to a customer. First, a bank is obliged to honour cheques and repay deposits. Secondly, a bank is obliged to collect cheques and other instruments on its customer's behalf. Thirdly, a bank is obliged to render accounts to a customer periodically or on the demand of the customer. Fourthly, the bank is obliged to maintain secrecy in relation to its customer's affairs.¹⁴ Within each of these four broadly defined duties, other specific duties have been implied in relation to their actual execution; for example, a bank is only obliged to honour cheques when there are suffi-

⁹ See M.H. Ogilvie, *Joint Bank Accounts and Overdraft Liability* (1985), 23 *Univ. West. Ont. L. Rev.* 67.

¹⁰ [1921] 3 K.B. 110 (C.A.).

¹¹ (1848), 2 H.L. Cas. 28, 9 E.R. 1002 (H.L.).

¹² There is an evolving body of case-law which suggests that in certain circumstances a bank will be the constructive trustee of a customer or even a third party, which originated in two English cases at first instance: *Selangor United Rubber Estates Ltd. v. Craddock (a bankrupt)* (No. 3), [1968] 2 All E.R. 1073 (Ch. D.) and *Karak Rubber Co. Ltd. v. Burden* (No. 2), [1972] 1 All E.R. 1210 (Ch. D.). Subsequent cases, including Canadian cases, will be discussed below.

¹³ For the numerous cases and further elaboration see M.H. Ogilvie, *Banking. The Law in Canada* (1985), pp. 263-265.

¹⁴ *Ibid.*, at pp. 266-283.

cient funds or an agreed overdraft facility and may refuse to pay when these prerequisites are not satisfied.¹⁵ In addition, there are established exceptional circumstances in which these duties no longer bind the bank; for example, banks are obliged to disclose their customers' affairs to third parties when there is a public duty to do so¹⁶ or under compulsion of law.¹⁷

Conversely, the common law has also implied several terms into the banking contract in relation to the customer's duties to the bank. First, a customer is obliged to take reasonable care in executing his written orders so as not to mislead the bank or facilitate forgery.¹⁸ A bank is not obliged to honour an ambiguous or suspicious instruction. Secondly, a customer is obliged to inform the bank as soon as he knows that a forged instrument has been presented or is about to be presented to it.¹⁹ Thirdly, there is growing evidence that in Canada, if not yet in England,²⁰ a customer owes a duty to verify the accuracy of the accounts rendered to him, even in the absence of an account verification agreement; otherwise he is estopped from re-opening them.²¹ Fourthly, there is at least one Canadian authority for the implication of a duty on the part of a large commercial

¹⁵ *Ibid.*, at pp. 266-267.

¹⁶ *Ibid.*, at pp. 281-282.

¹⁷ *Ibid.*

¹⁸ The foundation case was *Young v. Grote* (1827), 4 Bing. 253, 130 E.R. 764 (C.P.), but conclusive support only came in *London Joint Stock Bank, Ltd. v. Macmillan and Arthur*, [1918] A.C. 777 (H.L.) which has been applied or cited with approval in numerous Canadian and English decisions since. A particularly fulsome judicial discussion of the customer's duties to a bank is found in the judgment of Hunter J. in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*, [1984] 1 Lloyd's L.R. 555 (Hong Kong C.A.), at pp. 569-581; see also the comment of E.P. Ellinger, *Bank's Liability for Paying Fraudulently Issued Cheques* (1985), 5 Oxford Journal of Legal Studies 293.

¹⁹ *M'Kenzie v. British Linen Co.* (1881), 6 App. Cas. 82 (H.L.); *Ogilvie v. West Australian Mortgage and Agency Corporation Ltd.*, [1896] A.C. 257 (P.C.); *William Ewing & Co. v. Dominion Bank*, [1904] A.C. 806 (P.C.); *Morison v. London County and Westminster Bank Ltd.*, [1914] 3 K.B. 356 (C.A.).

²⁰ See *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*, [1985] 2 All E.R. 947 (P.C.) in which Lord Scarman for the Board aggressively refused to expand the scope of a customer's duties beyond the two enumerated above. The law of England was said to be the same as that of Hong Kong. See also, M.H. Ogilvie, *Bank Accounts and Obligations* (1986), 11 Can. Bus. L.J. 220.

²¹ See generally, *Columbia Gramophone Co. v. Union Bank of Canada* (1916), 34 D.L.R. 743 (Ont. S.C.); *Rutherford v. Royal Bank of Canada*, [1932] 2 D.L.R. 332 (S.C.C.); *B. & G. Construction Co. v. Bank of Montreal*, [1954] 2 D.L.R. 753 (Alta. S.C.); *Booth Fisheries Canadian Co. Ltd. v. La Banque Provinciale Du Canada* (1972), 7 N.B.R. (2d) 138 (N.B.S.C.); *Arrow Transfer Co. Ltd. v. Royal Bank of Canada* (1972), 27 D.L.R. (3d) 81 (S.C.C.), per Laskin J. (dissenting) at p. 88; *Number 10 Management Ltd. v. Royal Bank of Canada* (1976), 69 D.L.R. (3d) 99 (Man. C.A.); *C.P. Hotels Ltd. v. Bank of Montreal* (1981), 122 D.L.R. (3d) 519 (Ont. H.C.); aff'd. (1982) 139 D.L.R. (3d) 575 (Ont. C.A.).

customer owed to the bank to implement and utilize reasonable office and accounting procedures so as to facilitate the prevention of forgery.²²

Several observations may be made about these implied terms. First, the statements of these implied terms by the courts are primarily descriptive in nature with little indication of their substantive content, especially in regard to the standard of performance required. Secondly, regardless of their substantive content, by comparison with the foregoing summary of typical express banking contract terms, it is readily evident that whichever party is in breach of an implied obligation, the loss so caused falls on the customer in almost all instances by virtue of the written contract. Thus, the terms traditionally implied by the common law are of no real importance. There are, however, some exceptional situations; for example, where there is no account verification agreement and a court declines to import a verification duty on the customer's part into the contract, the bank will become the insurer of the customer's failure to take care on his own behalf.²³ Again, when the courts are reluctant to impose a general duty of reasonable care on a customer in relation to his own financial affairs *vis-à-vis* the bank, it may be that, in circumstances which fall outside the scope of the agreement as strictly construed, the bank would also become the customer's insurer.²⁴

Thirdly, the courts have proved reluctant to expand the scope of each party's duties beyond those enumerated above, as suggested by the tentative expression of the third and fourth duties placed on the customer by some courts. This reluctance may be examined from two perspectives, the customer's and the banker's. To increase the banker's duties to a customer in the face of the banking standard form contract, the courts have available to them the various techniques devised to control standard form contracts containing unfair terms and disclaimer clauses. Yet, there is only some indication in the case law that these may be invoked in relation to banking account contracts.²⁵ However, few opportunities have been presented to the courts for such determinations, and litigation typically has concerned corporate plaintiffs on whose behalf the courts have not traditionally sympathized in the standard form contracts context. In

²² *C.P. Hotels*, *supra*, footnote 21.

²³ As happened in *Tai Hing*, *supra*, footnote 20.

²⁴ As happened in *Tai Hing*, *supra*, footnote 20, or which could happen on facts similar to *C.P. Hotels*, *supra*, footnote 21 if not extended beyond sophisticated commercial customers.

²⁵ In *Tai Hing*, *supra*, footnote 20, the *contra proferentem* rule was applied and in *Stanley Works of Canada Ltd. v. Banque Canadienne Nationale* (1981), 20 B.L.R. 282 (Que. C.A.), per Montgomery J.A. at 287: "Any such document limiting liability should, in my opinion, be restrictively construed and any doubt resolved against him who seeks to avoid liability." That some courts, especially the Supreme Court of Canada, are reluctant to interfere with banking contracts is well-known; see, for example, *Bauer v. Bank of Montreal*, [1980] 2 S.C.R. 102.

addition, there is some indication that a few courts may be willing to impose a duty of care in tort to circumvent the contract.²⁶

Conversely, there is also evidence that the courts are equally hesitant to increase the scope of a customer's duties toward a bank at common law, even in the absence of express agreement and circumstances which might warrant the extension, apparently on the ground that banks are in a better position to suffer losses and to insure negligent customers. *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*²⁷ is a recent case in point. There the Privy Council declined to import into the contractual relationship customers' duties of account verification and of adoption of reasonable accounting procedures so as to impede employee forgery. Writing for the Board, Lord Scarman adopted the reasoning of a judge of the Kings Bench at the beginning of this century that banks could easily afford to compensate large losses suffered by their negligent customers!²⁸ It could be argued, however, that even if the defendant is a bank, it is, *prima facie*, patently unfair to make it the insurer when it was not responsible for the plaintiff's loss; moreover, decisions such as *Tai Hing* encourage a policy of confrontation between banker and customer on a matter in which their interests are mutually dependent and require co-operation to prevent losses.²⁹ It would appear, then, that at least in terms of the traditional approach to the implication of terms into the banker and customer contract, the common law is approaching an impasse.

A fourth observation is that while the terms implied by the common law appear to bestow a broad discretion on the courts, by virtue of lack of specific content, to determine factual matters, the standard written contract typically removes such factual issues from the consideration of the courts since the allocation of risk and of resulting loss to the customer effectively deems the facts to have been what they may not actually have been.

²⁶ For overlap issues in contract see: W.D.C. Poulton, *Tort or Contract* (1966), 82 *Law Q. Rev.* 346; G.H.L. Fridman, *The Interaction of Tort and Contract* (1977), 93 *Law Q. Rev.* 422; P.S. Atiyah, *Contracts, Promises and the Law of Obligations* (1978), 94 *Law Q. Rev.* 193; C. Considine, *Some Implications from Recent Cases on the Differences Between Contract and Tort* (1978), 12 *U.B.C. L. Rev.* 85; J. Irvine, *Contract and Tort: Troubles Along the Border* (1979), 10 *C.C.L.T.* 281; M. Bridge, *The Overlap of Tort and Contract* (1982), 27 *McGill L.J.* 872; J. Holyoak, *Tort and Contract After Junior Books* (1983), 99 *Law Q. Rev.* 591; J.C. Smith, *Liability in Negligence* (1984); M.H. Ogilvie, *John Maryon International Ltd. v. New Brunswick Telephone Co. Ltd.: Some Notes Toward an Obligations Theory of Concurrent Liability in Contract and Tort* (1984), 10 *Queens L.J.* 193; M.H. Ogilvie, *Rempel v. Parks: Plain Talk About Contract and Tort* (1985), 20 *U.B.C. L. Rev.* 149.

²⁷ *Supra*, footnote 20.

²⁸ *Ibid.*, at pp. 956-957, citing *Kepitigalla Rubber Estates, Ltd. v. National Bank of India Ltd.*, [1909] 2 *K.B.* 1010 (*K.B.D.*), per Bray J. at pp. 1025-1026.

²⁹ This theme is more fully explored in Ogilvie, *loc. cit.*, footnote 20.

Fifthly, the traditional common law duties of the banker and customer are essentially reciprocal and mutual in nature, whereas the express terms purport one-sidedly to allocate all the responsibilities to the customer. This mutuality is not often remarked upon, nevertheless it can be easily demonstrated. A customer is obliged to keep his account in funds; a banker is obliged to honour all mandates as long as the account is in funds. A customer is obliged to execute his written orders so as not to mislead the bank; a bank is obliged to honour unambiguous mandates. A customer is obliged to take steps so as not to facilitate fraud or forgery; a banker is obliged to collect all instruments on the customer's behalf. A bank is obliged to render accounts to the customer on a periodic basis; a customer is obliged to verify the accuracy of the accounts.

Additional evidence for the view that mutuality of obligation is fundamental to the traditional common law approach to the banker and customer relationship is found in several of the classical cases. Restatements in those cases of the implied terms often juxtapose the obligations, as done above, to emphasize their mutuality.³⁰ As well, there are express statements adopting such words as "mutual", "reciprocal" and "correlative" to describe the relationship. Thus, in *London Joint Stock Bank Ltd. v. Macmillan and Arthur*³¹ Viscount Haldane, speaking of the bank's duty to honour cheques, states:

The banker contracts to act as his mandatory and is bound to honour his cheques without any delay to the extent of the balance standing to his credit. The customer contracts *reciprocally* that in drawing his cheques on the banker he will draw them in such a form as will enable the banker to fulfil his obligation, and therefore in a form that is clear and free from ambiguity. The *correlative* obligation is thus *complementary* to the obligation of the mandatory to apply the balance in paying without delay the cheques as and when presented to him.

Later, Lord Shaw also spoke of the obligations as "reciprocal obligations".³² Again, in *Joachimson v. Swiss Bank Corporation*³³ both Bankes L.J. and Warrington L.J. defined the duties as "reciprocal" and as "mutual obligations", and Atkin L.J. begins his often-quoted statement of the duties of banker and customer, thus: "The terms of that contract involve obligations on both sides . . .". Finally, in *Greenwood v. Martins Bank Ltd.*,³⁴ Scrutton L.J. stated:

³⁰ See for example, *London Joint Stock Bank Ltd. v. Macmillan and Arthur*, *supra*, footnote 18, per Lord Finlay L.C. at p. 789; per Viscount Haldane at pp. 814-815; per Lord Shaw at p. 824; *Joachimson v. Swiss Bank Corp.*, *supra*, footnote 10, per Warrington L.J. at pp. 125-126; per Atkin L.J. at pp. 126-128; *Greenwood v. Martins Bank Ltd.*, [1932] 1 K.B. 371 (C.A.) (aff'd. [1933] A.C. 51 (H.L.)), per Scrutton L.J. at p. 381. See also: *Scholfield v. Earl of Londesborough*, [1896] A.C. 514 (H.L.).

³¹ *Supra*, footnote 18, at p. 814. (Emphasis added).

³² *Ibid.*, at p. 824.

³³ *Supra*, footnote 10, Bankes L.J. at p. 119; Warrington L.J. at pp. 125-126; Atkin L.J. at p. 127.

³⁴ *Supra*, footnote 30, at p. 381. (Emphasis added).

It seems to me that the banker, if a cheque was presented to him which he rejected as forged, would be under a duty to report this to the customer to enable him to inquire into and protect himself against the circumstances of the forgery. This, I think, would involve a *corresponding* duty on the customer, if he became aware that forged cheques were being presented to his banker, to inform his banker in order that the banker might avoid loss in the future. If this is correct there was in the present case silence, a breach of a duty to disclose, which may give rise to an estoppel.

Conversely, it should be noted that while the classical cases on the banker and customer relationship require mutuality and most subsequent cases presume it, some courts have declined to adopt that standard when asked to expand the scope of a customer's duty to a bank. That the third and fourth duties of account verification and of the adoption of reasonable accounting procedures have not found overwhelming support as correlatives of a bank's duty to provide statements of account may be indicative of the current apparent loss of direction in defining the banker and customer relationship. The reason for this hesitation would appear to be the deliberate adoption of a policy that the banks are best suited to bear strict liability for customers' losses except where the customer has been grossly negligent. The practicality and desirability of such a policy will be explored below.³⁵

Finally, there are contemporary indications that the courts may circumvent the problem of defining explicit duties by imposing a generalized duty of care on the parties to a banking contract, either in contract or in tort. Thus, in *C.P. Hotels Ltd. v. Bank of Montreal*,³⁶ the Ontario High Court, in a decision subsequently affirmed by a majority of the Court of Appeal, suggested that a large commercial customer owed a duty to implement proper accounting procedures in terms approximating duty of care language, and in *Tai Hing*³⁷ the Hong Kong Court of Appeal appears to have gone the full distance of importing a general duty of care into the contract, although the Privy Council was unwilling to follow. The adoption of this approach in relation to ordinary consumers would result in a massive re-allocation of the risk and loss in favour of the consumer customer since tort is clearly one of the techniques for overriding unfair terms. Unless the courts prove more sympathetic than at present to commercial parties, or more willing to impose tortious duties in the teeth of the contractual undertakings, it is unlikely that re-allocation in favour of commercial parties will result other than when the contract is silent as to the distribution of the risk. The adoption of a duty of reasonable care would also result, however, in the possibility that in those situations in which the standard form contract on strict construction is not applicable a customer would have to bear the loss when he was responsible for it,

³⁵ See also Ogilvie, *loc. cit.*, footnote 20.

³⁶ *Supra*, footnote 21.

³⁷ Hong Kong C.A.: *supra*, footnote 18; P.C.: *supra*, footnote 20.

wholly or in part. The re-allocation of the loss to the responsible party is, however, *prima facie* not a bad thing.

In Canada, the importation of a tortious styled generalized duty of care into the banking contract is proceeding along several routes of which the most important may be the development in various contexts of a duty of inquiry. The rest of this article is devoted to an analysis of these developments in relation to a number of aspects of the banker-customer relationship and of the relationship between the bank and third parties.

II. *Opening the Account and Honouring Cheques*

The banker and customer contract normally is formed when an account is opened with a bank, which then owes legal duties not only to the customer, but also, in certain instances, to third parties. Recent Canadian cases show increased awareness of the contractual implications of opening accounts, demonstrated in several decisions involving changes in the contractual terms initially "agreed upon". The courts have found that, in accordance with the ordinary principles of contract law, a bank must give notice of the changes in the operation of an account, and do so with a view to protecting the customer's interests as well as its own.

The decision of the Ontario Court of Appeal in *Thermo King Corp. v. Provincial Bank of Canada*³⁸ is a good example. Thermo, the plaintiff, was a manufacturer of refrigeration equipment and the defendant, Hamilton Transport Refrigeration Ltd., was one of its franchised dealers whose banker was the other defendant, Provincial Bank. The franchise agreement provided that Thermo would ship units to Hamilton on condition that Hamilton pay over funds as soon as they were received from purchasers of the units. In March 1976 Hamilton received three orders for Thermo units and on June 25th deposited a number of cheques totalling \$102,211 in its account and asked the bank to issue a draft for \$U.S. 100,000 payable to Thermo on that day so that Hamilton could get its dealer discount on the orders. Since the largest cheque had to be certified before the draft could be issued, Hamilton was told there would be a delay. In fact, over the next few days the bank decided to appoint a receiver-manager pursuant to debentures given by Hamilton and he took possession in the late afternoon of June 29th, 1976. The bank's evidence was that the large deposits sparked the bank's decision. For several years Hamilton had been in some difficulty and had given the bank an assignment of its book debts, debentures and personal guarantees. Hamilton had also guaranteed the debts of a related company.

Thermo sued Hamilton for the price of the units and Hamilton joined the bank, claiming damages for breach of contract, for deceit and for the

³⁸ *Supra*, footnote 3.

bank's interference with Thermo's contractual relations with Hamilton, as well as a declaration that the bank held the Canadian equivalent of \$U.S. 100,000 in trust for it. At trial, Parker A.C.J.H.C. found that the bank had not promised the draft as argued by Hamilton, and Thermo was thus left on appeal with an action in tort for the bank's alleged interference with its contract with Hamilton.

On appeal, some five issues arose. Of these, the critical issue was whether the bank should be permitted to proceed to receivership without first giving notice of a change in the operation of the account. More specifically, the bank had permitted Hamilton to operate on an overdraft for some time and the question was whether it should be obliged to give notice that it would no longer permit this; indeed, could it go further and appropriate funds in the account to itself and appoint a receiver without giving a reasonable opportunity to Hamilton to meet a demand to repay the loans owing? After an extensive analysis of the case law, Wilson J.A., writing for the court, found that, given the absence of overriding justifications for the bank's actions derived from the collateral security given to it by Hamilton, it was obliged to give notice that it would no longer permit the account to operate on an overdraft.³⁹ She then went on to find that the bank had induced breach of contract since it knew of the relationship with Thermo and that Hamilton's contract with Thermo would be breached if the draft was not issued, and had intended to cause the breach.⁴⁰

The clearly pronounced underlying rationale for the finding of the Ontario Court of Appeal was that the bank had acted entirely in its own interests. It had no legal right to "lower the boom"⁴¹ without prior notice to Hamilton, and it was the absence of the prior notice which rendered the bank's conduct unlawful. The Court of Appeal, in *obiter dicta*, also noted that had the bank had a lawful justification for its conduct it would have been entitled to put its own interests ahead of the conflicting interests of its customers or those dealing with its customer. "A banker has this right absent any course of dealing giving rise to a requirement of notice."⁴²

The ambit of *Thermo* is difficult to determine and may be quite narrow: it is wrongful for a bank to change the terms for the operation of an account without notice; otherwise, it is quite permissible for a bank to put its own interests ahead of its customers' without regard to the circumstances. That the Court of Appeal did not award punitive damages against

³⁹ Particular reliance was placed on *Johnston v. Commercial Bank of Scotland* (1858), 20 Dunl. 790 (S.C.) and *Cumming v. Shand* (1860), 5 H. & N. 95, 157 E.R. 1114 (Exch.). Interestingly, no reference can be found to the only other recent Anglo-Canadian decision on change of terms: *Burnett v. Westminster Bank, Ltd.*, [1966] 1 Q.B. 742, [1965] 3 All E.R. 81 (Q.B.D.).

⁴⁰ *Supra*, footnote 3, at pp. 270-271.

⁴¹ *Ibid.*, at p. 270.

⁴² *Ibid.*, at p. 272.

the bank despite its deliberate and calculated conduct may be further evidence that the court did not wish to have its decision considered as extending further than necessary. In view of the fact that running the account on an overdraft was an implied term, does the decision extend to changes in the express terms or to various customs, for example, giving reasonable notice of changes in service charges or of changes in characteristics of particular types of accounts? When is a bank permitted to put its own lawful interests above the lawful interests of a customer? Always—as suggested by *Thermo*? What is a lawful interest? The decision raises as many questions as it answers. Nevertheless, it can be said that the introduction of the notice requirement is a first step toward the further protection of a customer's interests in situations in which a bank is likely to appropriate funds in an account to its own uses.

Further confirmation that *Thermo* is indicative of a new willingness on the part of the courts sometimes to enforce contracts with a view to protection of the customer's interests may be found in *Re West Bay Sales Ltd.*⁴³ and *Fougere and Fougere v. Bank of Nova Scotia*.⁴⁴ In the former case the Bank of Montreal, having notice of a petition in bankruptcy against a customer, agreed that the customer's overdrawn account would be operated on the basis of joint signatures of the customer and the receiver. Subsequently, when the account was in funds, the bank appropriated \$4,576.04. Finding that these funds belonged to the receiver and not the customer, the Registrar in Bankruptcy held that the bank was not entitled to appropriate them to the customer's loan account and ordered their return to the trustee. Thus, the interest of the customer in ensuring that his creditors be re-paid as far as possible, so as to salvage whatever might have remained of his reputation, was protected. Again, in *Fougere* the plaintiffs executed two orders to their bank to transfer all of the funds in a savings account to another bank since they wished to use the funds to pay out a substantial trade creditor in order to obtain more inventory. The bank had previously asked the plaintiffs to repay in full all outstanding loans plus interest and had expressed considerable concern about the plaintiff's financial picture. The bank was not told of the reason why the orders to transfer the funds had been made and froze the accounts. Richard J. found that the Bank of Nova Scotia had wrongfully retained possession of the funds and disobeyed the plaintiff's mandate. The implied obligation to honour cheques where there are sufficient funds could not be changed implicitly without notice.

In contrast to these three cases there is one 1982 decision, *Toronto-Dominion Bank v. F.G. Connolly Ltd., Connolly and Connolly*,⁴⁵ in which a trial court found that, where a bank increased the interest rate on an

⁴³ (1979), 103 D.L.R. (3d) 342 (Ont. S.C., in Bankruptcy).

⁴⁴ (1983), 55 N.S.R. (2d) 320, 114 A.P.R. 320 (N.S.T.D.).

⁴⁵ (1982), 56 N.S.R. (2d) 289, 117 A.P.R. 289 (N.S.T.D.).

overdraft⁴⁶ to prime plus three and three-quarters per cent from prime plus one and one-quarter per cent and the customers did not complain on receipt of their monthly bank statements, the customers had implicitly agreed to the increased rate in the absence of reasonable notice. While this decision may be defended on estoppel grounds, it is arguably unconscionable to permit banks to give notice of changes in the account operation contract by actually proceeding with the change itself. Nevertheless the cases discussed earlier suggest that courts are increasingly sensitive to the balancing of a customer's interests in the banker and customer contract.

Thermo and West Bay also show that, in opening and operating accounts, a bank owes a duty to take care of the interests of third parties who may be affected by wrongful dealing with the account by the bank. That the scope of a bank's duty to third parties may be increasing in the context of opening accounts is also demonstrated in one other decision. In *J. & F. Transport Ltd. et al. v. Markwart et al.*⁴⁷ the plaintiff employed a bookkeeper, one Markwart, without inquiring as to his credentials or previous employment. Some two months after Markwart had started work, a representative of a halfway house informed J. & F. that Markwart had a record of engaging in fraud, and after discussions with Markwart, J. & F. decided that he should not be given signing authority. However, Markwart's duties included delivery of cheques payable to J. & F. to the Toronto-Dominion Bank and account reconciliation. About seven months after beginning to work for J. & F., Markwart opened an account with the Bank of Montreal in the name of "J. & F. Transport Ltd.", giving himself signing authority alone. The bank employee who opened the account did not obtain evidence as to incorporation of the company, names of signing officers, nor did the employee ask to see identification from Markwart or realize that the address and telephone numbers given referred to residential rather than business sections of the city. In short, there was clearly negligence on the part of the bank in not following its own required procedures for opening company accounts. Markwart deposited J. & F. cheques into the account and was not detected until Markwart's girlfriend showed J. & F. cheques from the Bank of Montreal printed in J. & F.'s name. Markwart was convicted of fraud.

J. & F. sued the Bank of Montreal for the amount of the cheques accepted by it, \$35,306.57 plus interest, and the defendant argued that

⁴⁶ An overdraft is treated as a loan by the common law: *Re Hone (a bankrupt). Ex parte The Trustee v. Kensington Borough Council*, [1950] 2 All E.R. 716 (Ch. D.). There is, apparently, no common law right to charge interest on an overdraft; however, all banking contracts invariably provide for interest to be paid, usually at the current rates for loans. Even if express provision were not made, it is a well-established custom of bankers to charge interest and undoubtedly the courts would adopt that custom. In addition to *Connolly*, see also *Toronto-Dominion Bank v. Mr. Klean Enterprises Ltd. et al.*; *Toronto-Dominion Bank v. Shinkaruk* (1983), 24 B.L.R. 92 (Sask. Q.B.).

⁴⁷ *Supra*, footnote 3.

J. & F. so conducted its own affairs as to permit the fraud to be perpetrated, and that it had been on notice of potential problems and should have acted accordingly. Batten J. found that Markwart's defalcations were the result of the bank's negligence in opening the account without ensuring that he had the proper authority. He relied upon two English trial decisions from the beginning of this century⁴⁸ to find that there is no duty on the part of an employer to take precautions to prevent forgery on the part of an employee, and distinguished *C.P. Hotels v. Bank of Montreal*⁴⁹ on the grounds that J. & F. was not a customer of the bank and therefore not in a contractual relationship with it, and that it was not a sophisticated commercial operation.⁵⁰ He also found that he had no evidence as to what the proper accounting procedure should be in a company of the size of J. & F., nor did he have sufficient evidence of negligence by J. & F. in failing to properly supervise Markwart.

Although Batten J. did not expressly frame the bank's obligation to J. & F. in legal terms, it seems clear that his finding amounted to the imposition of a duty of care in tort. This finding is paradoxical in that the learned judge was willing to use tort to circumvent the absence of contract in J. & F.'s favour without considering how the same technique could, on the reported facts, have been used in the bank's favour. The bank was found to owe a duty to J. & F. although it was unaware of the real J. & F.'s existence apart from Markwart, yet "the" J. & F. could equally have been held to owe a duty to the bank to conduct its affairs properly so as to prevent forgery since it knew of Markwart and of his previous record. If *C.P. Hotels* could be distinguished in J. & F.'s favour, then why not also in the bank's favour? J. & F. was in a position to prevent the forgeries and the bank was not. J. & F. was contributorily negligent in its own losses and the decision should have reflected that fact. Nor is there any reason why *C.P. Hotels* should not be extended to all customers; carelessness in the conduct of personal accounts is no different in essence from carelessness in the conduct of corporate accounts. It is a matter of degree.

Despite the ease with which one can cavil with the final outcome of the case, it does establish a principle which is defensible *per se*, that is, that banks may be liable to third parties when negligent in opening accounts as well as in operating them.

Examination of other recent Canadian case law in relation to opening accounts and the bank's duty to honour all mandates drawn on an account suggests that curial willingness to protect the customer's interests is not advancing uniformly on all fronts, nor are courts willing to assist custom-

⁴⁸ *Lewes Sanitary Steam Laundry Co. Ltd. v. Barclay & Co. Ltd.* (1906), 95 L.T. 444 (K.B.D.) and *Keptigalla Rubber Estates Ltd. v. National Bank of India Ltd.*, *supra*, footnote 28.

⁴⁹ *Supra*, footnote 21.

⁵⁰ *Supra*, footnote 3, at p. 212.

ers without regard to the equities of an individual case. Thus, in *Fougere*, while the court found that the bank had wrongfully refused to honour the plaintiffs' instructions, the damages awarded were limited to nominal damages because the plaintiffs were regarded as "non-trading" customers who suffered inconsequential loss in the absence of proven special damages. In so deciding the Nova Scotia Supreme Court applied two cases which have been universally condemned as wrong,⁵¹ and decided to construe the plaintiffs as non-traders because the cheque happened to have been drawn on a personal account, although the difficulties which lead to the decision to withdraw personal funds arose because of the bank's demands in relation to a business account. Not only could it be argued that the distinction between accounts is irrelevant when small businesses are the issue, it is also clear that the reputations of individuals could potentially be damaged as much as the reputations of businesses by wrongfully dishonoured cheques.

Again, in *Solomon v. Royal Bank of Canada*⁵² the Manitoba Queens Bench found that on the particular facts before it the bank had no duty to inquire whether a cheque presented for payment was the cheque for which a stop payment had been given. In that case a solicitor had signed a stop payment authorization in blank intended for a cheque drawn on his trust account; however, the bank clerk completed the form with details relating to the solicitor's general account, with the result that the cheque was honoured. Dewar C.J.Q.B. found that the evidence did not clearly disclose whether the error as to the account was made by the solicitor or the bank clerk during a prior telephone conversation. However, that the written authorization did not reflect the plaintiff's directions was entirely his own fault so that no duty of inquiry was placed on the bank to re-ascertain on which account the stop payment was placed. Finally, it is also clear that where a bank erroneously pays out on a stopped cheque as a result of a mistake of fact Canadian courts will continue to permit banks to recover the funds from the payee of the cheque.⁵³

⁵¹ *Gibbons v. Westminster Bank Ltd.*, [1939] 2 K.B. 882 (K.B.D.); *Henderson v. Bank of Hamilton* (1894), 25 O.R. 641 (Ont. H.C.), aff'd. (1895), 22 O.A.R. 414 (Ont. C.A.).

⁵² [1983] 2 W.W.R. 543 (Man. Q.B.).

⁵³ *Royal Bank of Canada v. LVG Auctions Ltd.* (1983), 2 D.L.R. (4th) 95 (Ont. H.C.), aff'd. (1984), 12 D.L.R. (4th) 768 (Ont. C.A.). See also *Kelly v. Solari* (1841), 9 M. & W. 54; 152 E.R. 24 (Exch.) and *Barclays Bank Ltd. v. W.J. Simms Son & Cooke (Southern) Ltd. and another*, [1979] 3 All E.R. 522 (Q.B.D.). This vexed topic is discussed by: A.M. Tettenborn, *Mistaken Payment of Countermanded Cheques* (1980), 130 New Law J. 273; Paul Matthews, *Money Paid Under Mistake of Fact* (1980), 130 New Law J. 587; Sanda Rodgers Magnet, *Inaccurate or Ambiguous Countermand and Payment Over Countermand* (1979-80), 4 Can. Bus. L.J. 297; J. Reynolds, *Countermand of Cheques* (1981), 15 U.B.C. L. Rev. 341; R.M. Goode, *The Bank's Right to Recover Money Paid on a Stopped Cheque* (1981), 97 Law Q. Rev. 254; Paget's *Law of Banking* (9th ed., 1982), Ch. 18 *passim*.

III. *Collecting Cheques and Other Instruments*

If the evidence of growing mutuality of obligation in the contexts of opening accounts and honouring cheques is mixed but hopeful, in the contexts of a bank's second and third common law duties of collecting cheques and rendering statements there are important developments. Since 1978 the Canadian courts have rediscovered and imposed a duty of inquiry on the banks in relation to both customers and third parties in honouring and collecting cheques, and have also imposed duties of account verification and the adoption of proper accounting procedures on customers in relation to the banks. The duty of inquiry will be examined in this section and the other duties will be examined in the next section, since they arise in connection with a bank's third common law duty of rendering statements.

To date, a duty of inquiry has been imposed with respect to two aspects of cheque collection, the ownership of funds paid into the bank and delays in the collection process. Each of these will be examined, first through the case law in order to define the content of the duty of inquiry, and then once defined, the duty of inquiry will be analysed as a legal doctrine. It will be argued that both the duty of inquiry and the duties of account verification and of adoption of proper accounting procedures amount to a duty of reasonable care imposed on each of the parties to the banking contract and owed mutually to one another. In short, it is argued that the simple, rudimentary contract envisaged in the classical banking law cases has given way to a relationship governed by a law of obligations, whether of contract or tort.

A. *Ownership of Funds*

Although a duty of inquiry has existed in the law of trusts for some time, it was apparently not taken seriously in Canadian banking law until the decision of the Supreme Court of Canada in 1980 in *Carl B. Potter Ltd. v. Mercantile Bank of Canada*.⁵⁴ The facts were somewhat complex. A company, Anil Canada Ltd., had operated a hardboard manufacturing factory in Nova Scotia for nine years. Plant effluent discharged into a nearby river and bay provoked the Department of the Environment to request that an industrial waste treatment plant be installed. In late February or early March 1975 tenders were called for the contract. About six tenders were received and two were seriously considered, one submitted by the appellant, Potter, and the other by a company, R.A. Douglas Ltd. As required by the "Instructions to Bidders", both companies had submitted certified cheques for ten per cent of the amount of the tender as evidence of good faith that, if awarded the contract, it would be carried

⁵⁴ (1978), 31 N.S.R. (2d) 28, 52 A.P.R. 428 (N.S.T.D.); (1979), 31 N.S.R. (2d) 402, 52 A.P.R. 402 (N.S.A.D.); [1980] 2 S.C.R. 343. (1980), 41 N.S.R. (2d) 573, 76 A.P.R. 573 (S.C.C.). As to the general law of trusts see any standard text.

out in accordance with the drawings and specifications. The instructions further provided that the cheque would be forfeited if the successful bidder defaulted; that cheques would be returned to unsuccessful bidders immediately following the award of the contract; and that the proceeds of the cheque of the successful bidder were to be placed in an interest bearing trust account which contained no other funds and no withdrawals were to be made, other than interest and, in due course, the repayment to the bidder within sixty days after acceptance of the contract work by the owner.

Once it had been determined that Potter and Douglas were the bidders in which Anil was most interested, the other bidders' cheques were returned, but in violation of the Instructions, Mr. Raju, vice-president of Anil, placed both cheques in a fixed term deposit in the Mercantile Bank at Halifax on April 21st, 1975. In the face of conflicting evidence as to the information given to the bank about the cheques, the trial judge, Richard J., found that Raju had told the bank that the cheques were from tenderers for the pollution project and were to be kept separate from other company funds. On May 7th, as a result of concerns expressed by the project engineer about the irregular deposit and in view of the selection of Potter as the successful bidder, Anil withdrew the Douglas funds and issued a certified cheque to Douglas. On May 9th, the term deposit containing now only the Potter proceeds matured and the bank placed those funds in Anil's collateral account, and on the same day transferred \$100,000 out of that account to retire some of Anil's indebtedness to the bank. Anil had not been informed of these actions, although it was the bank's normal practice to ask Anil for instructions when a term deposit reached maturity. There was considerable conflicting evidence as to what happened subsequently; however, the trial judge found that Raju learned of the deposit of the funds in the collateral account in mid-June but made no effort to contact the Mercantile until late August. Richards J. characterized this delay as "callous disinterest bordering on disdain", and Raju's conduct as "reprehensible".⁵⁵ By late September Anil's financial position had deteriorated to such a state that none of its cheques was honoured by the bank.

At trial in the Nova Scotia Supreme Court, the issue was the effect in law of the Mercantile's actions up to the transfer of the Potter funds into the Anil collateral account. The trial judge found that Anil's conversion of the two cheques into the term deposit was a serious breach of trust.⁵⁶ Indeed, he found that Raju knew he was in breach of the instructions and that his conduct was fraudulent.⁵⁷ He further found that the Mercantile had sufficient notice of the unusual nature of the Potter funds to put it on

⁵⁵ *Ibid.*, at pp. 436 (N.S.R., A.P.R.) (N.S.T.D.).

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*, at pp. 437.

inquiry to determine the exact nature of the funds before dealing further with them.⁵⁸ However, it did not know and could not be expected to know the express provisions of the "Instructions to Bidders".⁵⁹

Richard J. thought the issue he had to determine was unique and without precedent in that the bank unilaterally and without prior notice to the trustee had diverted funds from the term deposit. He found that the bank was a constructive trustee for Potter or at the very least was fixed with sufficient notice to be placed on its inquiry.⁶⁰ He further found that the Mercantile's failure to inquire and to deal with the money without notice to Anil amounted to negligence in handling the Potter funds. He found the Mercantile to be indebted to Potter for the entire amount of the original certified cheque which had accompanied the tender documents. Had Anil still been a viable company, Richard J. would have found it jointly and severally liable with the Mercantile.

In the Nova Scotia Court of Appeal, Coffin J.A. for the court, (Macdonald and Pace JJ. A. concurring) extensively reviewed the case law on a banker's duty of inquiry⁶¹ and agreed with the trial judge that the bank was put on inquiry and was negligent. However, the court also found that Potter was contributorily negligent for failure to notify the bank promptly of the misapplication of the deposit. Liability was apportioned at fifty per cent each pursuant to the Contributory Negligence Act.⁶² On appeal by Potter to the Supreme Court of Canada, Ritchie J., for the court, found in a brief judgment that Potter was not contributorily negligent because the Mercantile was trustee of the funds of the contractor and there was no precedent for the proposition that a beneficiary owed a duty to its trustee to ensure that the terms of the trust were observed. Thus, there was no duty on Potter to inquire into the internal accounting of the bank in its dealing with trust monies. The judgment of the trial judge was restored and the bank was liable for the full amount of the original certified cheque.⁶³

⁵⁸ *Ibid.*, at pp. 436.

⁵⁹ *Ibid.*, at pp. 437, 444.

⁶⁰ *Cartwright v. Lyster & Bank of Nova Scotia*, [1934] 2 D.L.R. 166 (Ont. C.A.) and *White v. Dominion Bank*, [1935] 1 D.L.R. 42 (Man. C.A.). *McPherson v. Dominion Bank*, [1935] 3 W.W.R. 390 (Man. C.A.) was distinguished.

⁶¹ Including *Sheffield v. London Joint Stock Bank Ltd.* (1888), 13 App. Cas. 333 (H.L.); *Thomson v. Clydesdale Bank, Ltd.*, [1893] A.C. 282 (H.L.); *Fonthill Lumber Ltd. v. Bank of Montreal* (1959), 19 D.L.R. (2d) 618 (Ont. C.A.); *Selangor United Rubber Estates v. Cradock (a bankrupt) (No. 3)*, *supra*, footnote 12; *Karak Rubber Co. v. Burden (No. 2)*, *supra*, footnote 12; *Groves-Raffin Construction Ltd. and Fidelity Insurance Company of Canada v. Bank of Nova Scotia and Canadian Imperial Bank of Commerce*, [1975] 2 W.W.R. 97 (B.C.S.C.).

⁶² R.S.N.S. 1967, c. 54, s. 1.

⁶³ *Supra*, footnote 54, at pp. 351-352 (S.C.R.), 582-583 (N.S.R., A.P.R.). In support of his finding of a duty of inquiry arising from there being a constructive trustee,

In *Potter* the Supreme Court clearly established that a bank owes a duty of inquiry to a third party in relation to money belonging to that third party deposited with the bank. But the nature of that duty is not clear. It can be said to arise when a bank has sufficient information to alert it to the possibility that a third party owns or has an interest in money that has been deposited. What is sufficient information may be difficult to determine. *Potter* provides no assistance for subsequent cases as to what constitutes sufficient notice and from whom it may come. In *Potter* the trial judge had found that the bank had been told that the cheques were from tenderers; indeed, Anil's evidence was that the bank's high praise for Potter in the course of a conversation about the project was a significant factor in the selection of Potter over Douglas.

However, it would also appear from *Potter* that the duty of inquiry placed on a banker does not require that the banker be a constructive trustee for the third party. While all three courts found that the Mercantile was a trustee, the trial judge found in the alternative that it was also negligent; the Court of Appeal simply said it was negligent; and, the Supreme Court did not address the issue specifically, but agreed with the trial judge generally. Thus, the decision raises the issue of whether the substance of the duty of inquiry is a duty of care which has been breached once a bank has converted funds to its own use. Moreover, the constructive trustee device is merely used as a remedial technique to restore funds to the third party.

Potter has been referred to or applied in a number of banking law decisions since 1980 and it remains to examine some of these with a view to the determination of the evolving nature of the duty of inquiry.

In *Baxter Equipment Ltd. v. Canadian Imperial Bank of Commerce and Trynor Construction Co. Ltd.*,⁶⁴ the plaintiff sued the bank for the recovery of \$34,237.43 representing the net proceeds from the auction sale of a caterpillar loader owned by Baxter. The bank alleged that the money belonged to one of its customers, Trynor Construction, and was paid to the bank without notice of Baxter's alleged interest. Trynor owed the bank about \$1,200,000 and also owed other creditors about \$300,000. The bank held a registered assignment of accounts receivable, two debentures and one fixed charge over other equipment, insurance premiums and guarantees. Trynor wished to purchase a crusher plant for which Baxter was the distributor, but since the manufacturer required a \$30,000 deposit and Trynor could not raise that sum, Baxter paid the deposit from its own

Ritchie J. relied upon *White, supra*, footnote 60; *Cartwright, supra*, footnote 60; and the following passage from Halsbury's Laws of England (4th ed.), vol. III, para. 60: "A banker may be a constructive trustee of money in his customer's account and in breach of that trust if he pays the money away, even on the customer's mandate, in circumstances which put him upon inquiry."

⁶⁴ (1981), 46 N.S.R. (2d) 590, 89 A.P.R. 590 (N.S.T.D.).

resources and in exchange Trynor offered as security the caterpillar loader which was valued at \$40,000. The invoice transferring title contained an incorrect serial number and model year. The bank knew that the loader had been used as security to finance the purchase and, as found by the trial judge, agreed to this in writing. The bank manager's letter cited the same serial number as the invoice. Subsequently, Trynor was forced to sell equipment at an auction to reduce its bank loan and the loader was included at a reserve price of \$41,000. Prior to the auction all three parties were made aware of the proper serial number and Baxter had reluctantly agreed to permit the loader to be included because of the reserve price. Baxter was advised by Trynor that it would be reimbursed the day after the auction. As a result of some misunderstanding and bickering as to where the proceeds of the auction would be sent, they were eventually sent to the bank for deposit in Trynor's account, and subsequently applied to the reduction of Trynor's loan. Trynor went into receivership. Baxter was never paid and was forced to buy the crusher plant itself.

In a brief judgment, Glube J. found that the bank knew of Baxter's interest in the money and deliberately chose to ignore it. She stated: "I find that the Bank knew or ought to have known of the trust or fiduciary obligation to Baxter while funds were still available from the auction and knew it was breaching the trust. The Bank was placed on its inquiry and the principles set forth in . . . [Potter] apply."⁶⁵

In contrast to Glube J.'s brief and simple application of *Potter*, Craig J. in the Ontario High Court undertook a fuller examination of the duty of inquiry in *Bank of Nova Scotia v. Bank of Montreal*.⁶⁶ The case concerned the plaintiff's customer, Irving Steel Ltd., which was indebted to the bank for over \$1,000,000, which was secured by a section 88 (now section 178) security, a debenture covering Irving Steel's plant and a general assignment of book debts which constituted an immediate absolute transfer to the plaintiff of all present and future debts. In 1979 the plaintiff advised Irving to make its banking arrangements elsewhere and Irving subsequently opened an account with the defendants who agreed to pay out the plaintiff in return for the security it held. On April 30th, 1977 Irving deposited a cheque for \$65,398.05 in the Bank of Montreal account; the cheque was subject to the section 88 security still in favour of the plaintiff. The plaintiff sued the defendant for a breach of trust, and claimed an accounting of the sum or damages for breach of trust. The trial judge found—as he could only find—that the defendant's manager knew more than enough of the facts and circumstances to put him on inquiry in dealing with such a large cheque.⁶⁷ The manager made no inquiries at all.

⁶⁵ *Ibid.*, at pp. 604.

⁶⁶ (1982), 19 B.L.R. 80 (Ont. H.C.).

⁶⁷ See the decision for several pages of facts which would put the bank on inquiry, *ibid.*, at pp. 85-90.

The trial judge phrased the issue as being whether the manager had at least sufficient knowledge to put him on inquiry as to whether a breach of trust was being committed and therefore whether the defendant bank was a constructive trustee of the plaintiff bank. To answer that question he regarded himself as obliged to distill from earlier case law a test for the determination of what is sufficient knowledge to create a duty of inquiry. After examination of *Potter* and the English trial decisions, *Selangor*⁶⁸ and *Karak*,⁶⁹ Craig J. decided that the test for the existence of a duty of inquiry is objective: were the facts of sufficient significance so as to place a prudent banker on inquiry?⁷⁰ He further added that where the bank stands to gain from the transaction a presumption is created that a breach of trust is about to be committed.⁷¹ The learned judge then found that, although the manager did not know that the cheque belonged to the plaintiff and did not act with dishonesty, the circumstances were sufficient to alert a "prudent banker" or "any honest, reasonable banker"⁷² to the likelihood that the cheque belonged to the plaintiff and was subject to a fiduciary obligation. The defendant bank was the constructive trustee for the plaintiff bank and in breach of its duties.

The third case in which *Potter* was recently applied was a decision of the Saskatchewan Court of Queens Bench, *Overhead Door Company of Regina (1973) Ltd. v. Saskatchewan Economic Development Corp. et al.*⁷³ This case concerned a dispute over the sum of \$51,000 which the plaintiff alleged had been appropriated from a bank account by one of the defendants, the Canadian Imperial Bank of Commerce, in breach of trust. The sum was part of the proceeds of a cheque paid by the first defendant, the Saskatchewan Development Corporation, to two companies, Lux Service Ltd. and Farmstead Builders (Yorkton) Ltd., the latter a general contractor retained by Lux to construct a building for it. The construction was being financed by the Development Corporation and the Royal Bank of Canada, and the cheque was the final advance from the Development Corporation. It was deposited on December 17th, 1982 in Farmstead's account, and on that same day the bank withdrew the disputed sum and applied it to Farmstead's overdraft. The trial judge found there was con-

⁶⁸ *Supra*, footnote 12.

⁶⁹ *Ibid.*

⁷⁰ *Supra*, footnote 66, at pp. 92, 94.

⁷¹ *Ibid.*, at pp. 94-95; citing *Gray v. Johnston* (1868), L.R. 3 H.L. 1, per Lord Cairns L.C., at p. 11; *British America Elevator Co. v. Bank of British North America*, [1919] A.C. 658 (P.C.) and *Fonthill Lumber Ltd. v. Bank of Montreal*, *supra*, footnote 61. Craig J. also rightly distinguishes a statement from I. Baxter, *Law of Banking* (3rd ed., 1981), p. 36 which is clearly wrong: "[T]here is no general duty on a bank to act as a watchdog in regard to its customer's business and the possibility of a breach by the customer of a fiduciary duty."

⁷² *Supra*, footnote 66, at p. 95.

⁷³ (1984), 37 Sask. R. 313 (Sask. Q.B.).

siderable evidence that the bank knew the purpose of the cheque and that it was subject to a statutory trust in favour of various workmen, suppliers and others, pursuant to the Mechanics Lien Act.⁷⁴ Lux's accountant had spoken to the bank manager about Farmstead's impending bankruptcy and Lux's concern that those with a statutory lien over the money would be paid. Moreover, the bank knew about the Lux building and the purpose of the Development Corporation's cheque. The plaintiff sought a declaration that the bank held \$51,000 on trust for it and that the sum had been wrongfully appropriated.

Estey J. found that the bank's knowledge of Farmstead's affairs was sufficient to put it on inquiry to determine whether any of the money was owed to third parties. In so finding he referred⁷⁵ to two cases specifically concerned with a bank's duty in relation to mechanics liens,⁷⁶ as well as *Potter*. The bank was found to hold the sum in trust subject to further directions in relation to other issues raised.

In the fourth case in which *Potter* has recently been applied, *Halifax Insurance Company v. Canadian Imperial Bank of Commerce*,⁷⁷ the plaintiff was one of five insurance companies involved in a consolidated action in which it sought money alleged to belong to it which was on deposit in a bank account of its agent, Carl Winsor Insurance Ltd. The funds represented insurance premiums collected by Winsor on behalf of the companies for which it was an agent and held in a separate premium trust account, as required by the company, along with the premiums collected on behalf of the other companies. On June 1st, 1982 Winsor went into bankruptcy after several years of financial difficulties, during which time the defendant periodically appropriated premium monies from the premium account to Winsor's debt to the bank. Finally, in May 1982, when Winsor's indebtedness to the bank amounted to approximately \$600,000 and its premium account was in substantial funds, it appropriated a large sum of money from the account and stopped honouring Winsor's cheques.

The trial judge, Lang J., found that the bank had clear notice that the account contained insurance premium funds as evidenced by a letter written by Winsor to the bank, and as well by some eleven letters from the bank's internal correspondence which clearly indicated that the bank had full knowledge of the nature of the funds deposited in the account and that Winsor itself held them as trustee for the insurance companies. Given its knowledge, the bank had a duty to inquire into the character of the money as belonging to the insurance companies. The bank was the constructive trustee of the funds for the plaintiff and obliged to restore them to it.

⁷⁴ R.S.S. 1978, c. M-7, s. 3(1).

⁷⁵ *Supra*, footnote 73, at pp. 318-319.

⁷⁶ *Fonthill Lumber Ltd. v. Bank of Montreal*, *supra*, footnote 61; *Perlmutter Shore Ltd. v. Bank of Montreal* (1982), 40 C.B.R. (N.S.) 2 (Ont. S.C.).

⁷⁷ (1985), 52 Nfld. and P.E.I.R. 107, 153 A.P.R. 107 (Nfld. T.D.).

A fifth and final recent Canadian case in which the duty of inquiry as set out in *Potter* was considered was *Taran Furs (Montreal) Ltd. v. Canadian Imperial Bank of Commerce*,⁷⁸ in which *Potter* was distinguished. Here the plaintiff was once more suing the defendant for breach of trust and, in the alternative, for negligence, in relation to a sum of \$36,160 appropriated from the bank account of a retailing company, the London, New York, Paris Association of Fashion Ltd. London had been experiencing financial problems for some time and was subject to close monitoring by the defendant, when in December 1981 it approached the plaintiff to purchase furs for resale. Taran knew of London's problems and instead of extending credit to it devised a scheme whereby Taran would deliver an inventory of furs, valued at \$93,400, on consignment. It was apparently agreed that the unsold furs and the proceeds from sales would be returned to Taran less twenty per cent which London would earn on sales. The defendant was also found to have agreed to honour all cheques made out to Taran; however, no separate trust account was established for the proceeds of the Taran furs sales, and the funds were mingled with London's other funds. On December 24th, 1981 a cheque for \$20,000 was drawn in favour of Taran, but by January 8th, 1982, when the cheque was presented for payment, London had made an assignment in bankruptcy and the cheque was returned "N.S.F.". Taran claimed the sum of \$20,000 which represented its share of the proceeds of the sold furs, as well as the value of the furs not returned but presumably sold, worth another \$20,000. The other furs had been returned.

Goodridge J. found that the defendant's only undertaking was to honour cheques payable to Taran; moreover, he also found no evidence that the bank knew much about the specific arrangements in relation to the furs. After an analysis of *Potter* he stated the test for whether the bank owed a duty of inquiry thus: "[I]t seems clear that the circumstances which would place a bank upon its inquiry are circumstances where it has knowledge that the funds which it is handling are trust funds of which the customer is trustee."⁷⁹ He further noted the need for the funds to be of an "unusual nature"⁸⁰ and stated: "Where there is a prospective use of funds that would appear, on the surface, to be irregular, the bank is placed upon its inquiry."⁸¹ The learned trial judge then held, in the face of the very evidence reported earlier in his decision, that the bank never knew it was handling Taran funds. This conclusion was reached on the basis that the bank had not been *expressly* informed that *specific* deposits represented Taran furs sales proceeds, nor *expressly* informed that the \$20,000

⁷⁸ (1984), 49 Nfld. and P.E.I.R. 128, 145 A.P.R. 128 (Nfld. T.D.).

⁷⁹ *Ibid.*, at pp. 136.

⁸⁰ *Ibid.*, at pp. 136 and 137.

⁸¹ *Ibid.*, at pp. 136.

cheque payable to Taran represented those proceeds. *Taran* was further distinguished from *Potter*:⁸²

It should be noted that the duty to inquire referred to in the *Potter* case was a duty to inquire whether or not the use of the fund known to be impressed with a trust or known to have "an unusual nature" was regular and not a duty to inquire whether the fund itself was a trust fund or had an unusual nature. There is a marked difference between these two situations. The *Potter* case related to the former; this case relates to the latter.

Goodridge J. concluded that there were no circumstances such as to impose a duty on the bank to inquire into the ownership of the funds here. He further found that the bank's undertaking to honour all cheques payable to Taran did not create a trust, but rather was a "simple undertaking on the part of the bank".⁸³ Nor did the trial judge accept Taran's argument that this undertaking amounted to a negligent misrepresentation within the scope of *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*,⁸⁴ because the bank's undertaking to honour Taran cheques related to future behaviour rather than the giving of wrong information.⁸⁵ He finally found that the statement did not amount to a guarantee since there was no memorandum in writing as required for enforcement, and that there was no equitable estoppel.⁸⁶ Thus, Taran had no claim against the bank for the sale proceeds.

This case was clearly wrongly decided, apparently because of a misunderstanding of *Potter*. In *Potter* the defendant bank had notice of the unusual nature of the funds, but did not know specifically that Anil held them on trust or the specific details of the bidding process; thus, on the facts alone the distinction of *Potter* is based on an inaccurate factual understanding of the trial judge's findings. Again, even if that were not so, it is hard to see why the bank in *Taran* had not, in the trial judge's view, sufficient notice, given the evidence about Taran's discussions with it about London's financial difficulties and Taran's concern, to which the bank acceded, that cheques made payable to it be honoured. Nor is it clear that the distinction between a duty to inquire whether the use of a fund impressed with a trust was regular and a duty to inquire whether funds are trust funds is legally meaningful. If the function of a duty of inquiry owed to a third party is to protect that third party's interests in factual circumstances in which the bank should be alerted to them, then the important question is whether or not the factual circumstances are sufficient to impose that duty on the bank, not whether the funds are or are not known to be trust funds. Whether funds are trust funds will follow from the inquiry prompted by the information known to the bank.

⁸² *Ibid.*, at pp. 137.

⁸³ *Ibid.*

⁸⁴ *Supra*, footnote 4.

⁸⁵ *Supra*, footnote 78, at pp. 137-138.

⁸⁶ *Ibid.*, at pp. 138.

Gathering all of the *Potter* cases together it is possible to formulate at least four major questions which the courts must face in situations in which a bank has appropriated funds from a customer's account to reduce the customer's indebtedness to it and in which a third party claims an interest. First, in what circumstances will a bank be placed on inquiry? Secondly, once placed on inquiry, how much inquiry is expected of a bank to fulfil its duty? Thirdly, what is the nature of the legal right which is established when a bank is placed on inquiry and to whom is it owed? Fourthly, what remedies flow from a breach of that right? To date, the cases have only begun to answer these questions.

The first question is the most important and one to which the courts to date have provided only some assistance to future courts, since in all of the cases, including *Taran*, the banks clearly had sufficient information about the transactions in question. In *Potter*, *Halifax Insurance*, *Overhead* and *Taran* the banks were expressly told that the cheques deposited with them related to a specified transaction in which a third party was involved. In *Baxter* and *Bank of Nova Scotia* the banks were aware of the transactions in question and, if not specifically informed about the cheques deposited, had sufficient information to justify the expectation that they would fully inform themselves. Of these cases, *Baxter* is the one in which the banks had the least information, but unfortunately the decision of the trial judge in *Baxter* is also the most cryptic. Thus, it is difficult to draw guidance from it for future cases.

However, it does seem clear, although only *Bank of Nova Scotia* addressed the matter, that the test for the creation of a duty of inquiry is objective rather than subjective. Would the circumstances alert the reasonably prudent banker to inquire further into the ownership of funds deposited with him? This objective test appears to have been applied implicitly in the other cases, especially *Baxter* and *Bank of Nova Scotia*, in which the banks had no actual knowledge of the specifics of the transactions in question. However, again it is not certain how informative the application of the prudent banker test is in these two cases, since their respective circumstances are those in which bankers ought to know about third party interests; those are, when debt accounts are being transferred from one bank to another and when equipment knowingly held as security is sold. Again, in *Overhead*, had the bank no other source of information, it should be expected to know about mechanics liens on buildings under construction. But in relation to less obvious situations it remains to be seen what knowledge a prudent banker should be deemed to have to place him on inquiry. From the third party's perspective, it can be said at least that the duty of inquiry is now firmly established and it is up to future third party plaintiffs to show when banks will owe such a duty.

The second and related question is that of how much inquiry is expected of a bank, and to date the cases offer no real guidance. The test

of the reasonably prudent banker is presumably the appropriate one, but it remains to be seen how the law will develop.

The more important question is, however, the third one. The courts have phrased the duty as one of inquiry and deemed a banker who has not fulfilled the duty a constructive trustee for the third party plaintiff. On closer examination, it would appear that the mischief complained of is the bank's failure to use information at its disposal in dealing with its customer's accounts in breach of a duty of care owed to the foreseeable third party interest in cheques collected on behalf of the customer. This constitutes negligence, that is, carelessness in using received information which should alert the bank to inquire further before appropriating funds from an account. The substance of the breach of the so-called duty of inquiry is, then, negligence. It may be that one of the reasons why the courts have phrased the duty as one of inquiry rather than of negligence is that they have allowed the remedy to determine the legal nature of the right. It would appear that the constructive trust is used in these cases as a remedial device rather than as a substantive legal right, and it may be that once the courts had slipped into the language of trust law in relation to the remedy they continued in the same language in defining the right which had been breached. A second reason may simply be that in *Potter Ritchie J.* relied on two older somewhat analogous Canadian cases in which banks were held to owe duties of inquiry in rather different contexts, and that subsequent *Potter* cases simply applied *Potter* without further consideration of the impact of *Donoghue v. Stevenson*⁸⁷ on the matter. It is submitted that future cases ought to explore the possibility that failure to inquire amounts to negligence in the conduct of a customer's account.

The fourth question has been addressed; the *Potter* cases have imposed a constructive trust on a banker in favour of a third party. However, it follows from the suggestion that has just been made that these cases are explicable in tort and that the constructive trust is not the only remedial approach available; an award of damages calculated on the basis of the party's alleged loss is also clearly a possible approach.

That a banker's duty to a third party with respect to funds in a customer's account is really one of care may also be seen in two related English trial decisions of such forbidding and impenetrable complexity that they have rarely been analysed, *Selangor United Rubber Estates Ltd. v. Cradock (a bankrupt) (No. 3)*⁸⁸ and *Karak Rubber Co. Ltd. v. Burden (No. 2)*.⁸⁹ In both cases the issue was different from that under consideration in that it concerned a bank's obligation not to knowingly participate in a misuse of funds, rather than to inquire into the ownership of funds;

⁸⁷ [1932] A.C. 562 (H.L.).

⁸⁸ *Supra*, footnote 12.

⁸⁹ *Supra*, footnote 12.

however, the approach of the courts is applicable to all factual circumstances in which a bank deals with funds in a customer's account without making inquiry. Both cases concerned a situation in which a bank had allegedly breached its duty as constructive trustee of money in a customer's account by honouring cheques in circumstances in which inquiry ought to be made. In both cases company directors abused their signing authority over company bank accounts to engage in fraudulent and dishonest transactions in circumstances in which the defendant banks were deemed to be placed on inquiry and have knowledge of the illegal nature of the transactions. In both cases the Chancery Division found that the circumstances were such as to place a reasonable banker on inquiry and that the banks were liable to the customer in equity for breach of trust and in common law for breach of an implied contractual duty of care. In *Selangor*, the broad nature of a banker's duty was thus stated by Ungood-Thomas J.:⁹⁰

... a bank has a duty under its contract with its customer to exercise "reasonable care and skill" in carrying out its part with regard to operations within its contract with its customer. The standard of that reasonable care and skill is an objective standard applicable to bankers. Whether or not it has been attained in any particular case has to be decided in the light of all the relevant facts, which can vary almost infinitely. The relevant considerations include the *prima facie* assumption that men are honest, the practice of bankers, the very limited time in which banks have to decide what course to take with regard to a cheque presented for payment without risking liability for delay, and the extent to which an operation is unusual or out of the ordinary course of business. An operation which is reasonably consonant with the normal conduct of business (such as payment by a stockbroker into his account of proceeds of sale of his client's shares) of necessity does not suggest that it is out of the ordinary course of business. If "reasonable care and skill" is brought to the consideration of such an operation, it clearly does not call for any intervention by the bank. What intervention is appropriate in that exercise of reasonable care and skill again depends on circumstances.

He further stated:⁹¹

As between the company and the bank, the mandate in my view, operates within the normal contractual relationships of customer and banker and does not exclude them. These relationships include the normal obligation of using reasonable skill and care; and that duty, on the part of the bank, of using reasonable skill and care, is a duty owed to the other party to the contract, the customer, who in this case is the plaintiff company, and not to the authorised signatories. Moreover, it extends over the whole range of banking business within that contract. So the duty of skill and care applies to interpreting, ascertaining, and acting in accordance with the instructions of a customer; and that must mean his really intended instructions as contrasted with the instructions to act on signatures misused to defeat the customer's real intentions. Of course, *omnia praesumuntur rite esse acta*, and a bank should normally act in accordance with the mandate—but not if reasonable skill and care indicate a different course.

⁹⁰ *Supra*, footnote 12, at pp. 1118-1119.

⁹¹ *Ibid.*, at p. 1119.

And, again in *Karak*, Brightman J. said:⁹²

In my view the Achilles heel of the bank's argument, both in the *Selangor* case and in the case before me, is that it is not, and never reasonably could be, asserted that a paying bank with certain knowledge that the authorised signatories are misapplying the company's funds may nonetheless rely on their signatures. If that is axiomatic, and it was conceded so to be in the case before me, it seems utterly irrational to suppose that a bank has an absolute unqualified duty to pay and no duty to enquire despite a deep suspicion, approaching but falling short of a certainty, that the funds are being misapplied. Once a bank disclaims the untenable position of being in all cases an automatic cash dispenser, whatever the circumstances, there is no rational stopping-place short of a contractual duty to exercise such care and skill as would be exercised by a reasonable banker in similar circumstances. And that care and skill must rationally include, in appropriate circumstances, a duty to enquire before paying. I appreciate the simplicity and convenience of counsel's able submission, particularly in an age when banking transactions are reckoned in their daily millions and a rapid turnover of staff may present practical difficulties. But on the broader view expediency is not a persuasive argument for excusing a banker from enquiring in all circumstances short of certainty, when of course enquiry would be needless. Without, therefore, reference to authority I would myself be disposed in principle to adopt, without any qualification, that contractual duty of care which has been propounded by the learned judge in the *Selangor* case, because it seems to me rational.

In the light of these statements of general principle it is easy to see that the *Potter* cases are groping toward the imposition on banks of a duty of care, whether in contract or tort, in dealing with funds deposited and collected into a customer's account. When such a duty is breached the bank is deemed to be the constructive trustee for the customer or a third party to whom the duty was owed, and the money returned. If, then, there is no real mystery as to what is really happening in the *Potter* cases, it remains to inquire whether it is appropriate to import such a duty into the banker and customer relationship in relation to cheque collection. In answering this question two points must be remembered. First, the duty is one of reasonable care, not strict liability. Secondly, when a bank collects a large sum of money for deposit in the account of a customer in overdraft, the bank is almost invariably in a conflict of interest position once a duty of inquiry is imposed on it. On the one hand, the bank may in good faith think that it has a prior interest in the funds pursuant to security it has taken; yet, on the other, it may have a duty to hold the funds for a third party or a customer. Except where there are clearly established prior statutory liens, such as for employees' wages, it may not be certain until judicial adjudication of a dispute who has the first interest in the funds collected, the bank or the party for whom the bank is the alleged constructive trustee. In short, in such cases banks usually have a perfectly valid legal claim but not necessarily the prior one.

The appropriateness of importing a duty of inquiry into the banker and customer relationship may in the final analysis be dependent on its

⁹² *Supra*, footnote 12, at p. 1231.

practicality: given the volume of cheques processed daily can a bank be expected reasonably to exercise a duty of inquiry in relation to certain funds collected or in relation to certain customers? *Prima facie* the answer must be no. In *C.P. Hotels*,⁹³ for example, there was evidence that each verification clerk in the defendant bank processed about eight thousand cheques daily. Yet, it is entirely possible today to devise a computer program to flag funds collected for deposit in problem accounts and then to expect the bank to deal with these individually. Moreover, to assist banks in this process it is not unreasonable to place a correlative duty on a customer to ensure that a bank is informed of unusual transactions or of cheque collections involving funds held in trust for third parties. This can be arranged on an itemized basis or prior to each new course of dealing between a customer and a third party. The *Potter* cases to date suggest that it is practical to place such a duty on a customer, and that, indeed, it is normal banking practice, since in those cases the customer or the third party notified the various banks in one way or another of the unusual nature of the transaction in question, and on this basis the courts were able to reach their decisions that the banks had sufficient notice to import a duty of inquiry that was breached. If, as a practical matter, some customers or concerned third parties are already alerting banks about unusual transactions there can be little doubt as to the legal propriety both of importing a correlative, mutual and complementary duty of care into the banker and customer relationship and of keeping the duty at the level of reasonableness rather than of strict liability. Bank standard form contracts which attempt to transfer completely the risks of operating bank accounts to a customer should clearly not be upheld on public policy grounds. Causation of loss and actual loss should not be separated.

B. Delays in Collection

The second area in relation to cheque collection in which the courts have recently placed a duty of inquiry or of care on banks is with respect to the exercise of reasonable care by a bank on its customer's behalf in the clearance of cheques through the national clearance system, especially when there are delays. This issue arose in the highly contentious case, *Stanley Works of Canada Ltd. v. Banque Canadienne Nationale*⁹⁴ and as well in *National Slag v. Canadian Imperial Bank of Commerce*.⁹⁵ In the former case, Stanley Works, a manufacturer in Hamilton with an account at the Royal Bank of Canada, was given a series of post-dated cheques in

⁹³ *Supra*, footnote 21, at p. 523 (Ont. H.C.).

⁹⁴ (1981), 20 B.L.R. 282 (Que. C.A.). See also Jerome Choquette, Comment (1982), 60 Can. Bar Rev. 746 and Bradley Crawford, Letter to the Editor (1983), 61 Can. Bar Rev. 921.

⁹⁵ (1982), 140 D.L.R. (3d) 473 (Ont. H.C.); (1985), 19 D.L.R. (4th) 383 (Ont. C.A.).

1974 by a customer, Daly and Morin Ltd., of Lachine, Quebec, drawn on a Montreal branch of the respondent Banque Canadienne Nationale. A number of these cheques were duly paid by the Banque Canadienne Nationale. However, when the Royal Bank presented a cheque dated July 25th, the Banque Canadienne Nationale debited the Daly account but retained the cheque because of doubts as to the customer's solvency. When a second cheque for \$22,000 dated August 1st was presented the Banque Canadienne Nationale returned both cheques to the Royal Bank marked "N.S.F.", reversed the debits in the Daly account and realized on its security, thereby forcing Daly into bankruptcy. The Royal Bank accepted the return of the two cheques, debited the Stanley account and, at the request of Stanley, wrote to the Banque Canadienne Nationale on August 12th to ask for an explanation of the delay.

Initially, Stanley Works sued only the Banque Canadienne Nationale for the amount of the two cheques, \$44,000, on the ground that the eleven day delay with respect to the first cheque and the four day delay with respect to the second cheque contravened a clearing house rule in effect as between banks that a cheque in the possession of the drawer's bank for more than forty-eight hours is deemed to be paid. When the Banque Canadienne Nationale contested this on the ground that the rule was a custom as between banks only, the appellant sued the Royal Bank on the ground that it failed to exercise reasonable diligence for the protection of its customer's interests and that the standard of care was essentially that found in the forty-eight hour rule.

The action against the Banque Canadienne Nationale was dismissed on the ground of absence of privity, but upheld against the Royal Bank of Canada. In the Quebec Court of Appeal, Montgomery J.A., for the court, found that between the two banks the Royal Bank could have insisted that the Banque Canadienne Nationale honour the cheques because they were not returned within forty-eight hours, and further wondered whether the Royal Bank would have been so slow to act had its customer become insolvent before the return of the cheques. Undoubtedly, the Royal Bank would have been quick to protect its own interests in such circumstances! The court found that, while the clearing house rules were binding only as between banks, yet, "they provide an indication of what a bank can do and may reasonably be expected to do to protect its customers' interests".⁹⁶ The Royal Bank's conduct was characterized as "more than a simple error of judgment",⁹⁷ rather it was "the neglect of the bank to exercise what appear to have been its clear legal rights, thereby prejudicing its customer".⁹⁸ On strict construction, the account verification agreement did not relieve the Royal Bank of liability for the \$44,000.

⁹⁶ *Supra*, footnote 94, at p. 287.

⁹⁷ *Ibid.*

⁹⁸ *Ibid.*

Stanley Works has been said to rest on a non-existent clearing rule; moreover, Crawford has argued that since the courts in other cases⁹⁹ have found that the clearing rules bind only the banks, they cannot be used to create rights for customers.¹⁰⁰ In response, however, it must be said that whatever might be the real rule—and undoubtedly there are extensive and detailed rules governing the clearance of cheques in Canada¹⁰¹—these rules constitute, *prima facie*, the best standard for banking conduct in the collection of cheques on a customer's behalf. It is trite to observe that commercial conduct has normally been the measure adopted by the courts for a legal standard of care!

The same issue arose in *National Slag*, although as the plaintiff suffered no loss as a result of the breach of the clearing rules the court did not engage in a detailed examination of the issue. In that case a company, General Concrete Ltd., drew a cheque on the Bank of Montreal in favour of National Slag to which it was indebted. National deposited the cheque in its account at the Canadian Imperial Bank of Commerce and the cheque was subsequently forwarded through the clearing system. The cheque had been deposited on January 17th, but did not arrive at the Bank of Montreal branch until January 21st. In the ordinary course of business it should have arrived on the January 18th. The branch account manager postponed the decision to accept or refuse payment. General Concrete was indebted to the branch for more than \$3,500,000 and the bank had securities on all of the company's assets. On Friday, January 18th the branch had been instructed to call the loan and this was done on Monday, January 21st at 8:50 a.m. A receiver-manager was appointed the following day and on that same day the decision to dishonour the cheque was made. On January 23rd it was returned to the clearing system and reached the Canadian Imperial Bank of Commerce branch on January 25th. Debts and credits were reversed so that, as of January 25th, National Slag was left with an "N.S.F." cheque.

The plaintiff sued its bank for breach of a duty to inquire whether the cheque could be properly returned prior to debiting its account, and also sued the Bank of Montreal in negligence for breach of a duty to pay or refuse to pay without delay. There was evidence of a clearing rule which provided that, if a cheque is held by a drawee branch beyond the business day following the date of its receipt, it could only be returned through the

⁹⁹ *Parr's Bank Ltd. v. Thomas Ashley & Co.* (1898), 14 T.L.R. 563 (Q.B.D.); *W.J. Lafave & Sons Ltd. v. Banque Canadienne Nationale*, [1977] C.S. 802 (Que. S.C.), per Martel J. at p. 804.

¹⁰⁰ *Loc. cit.*, *supra*, footnote 94, at pp. 922-923.

¹⁰¹ The clearing house rules are not available to the public, nor despite three requests for information about the rules in relation to the preparation of this article was I able to ascertain what the specific rules are as relevant to the *Stanley Works* case. It may be that the rule on which the Quebec Court of Appeal rested its decision was rule 5 of section A4 which was at issue in *National Slag*.

clearing system if certified.¹⁰² There was also evidence that the Bank of Montreal's policy was to pay or dishonour cheques on the day of their receipt through the clearing, and that the delay by the Bank of Montreal was a clear breach of its own standards as well as those of the other chartered banks.

The trial judge, Labrosse J., found that, although both banks had acted improperly, National Slag had suffered no prejudice because the Bank of Montreal had the right to call its loan and did so within the proper clearing period. The Ontario Court of Appeal agreed. Thus, in *obiter dicta* only, the Ontario courts would appear to have concurred with the approach of the Quebec Court of Appeal, both suggesting that banks owe a duty of inquiry or of care to customers in relation to delays in collection through the clearing system.

IV. *Rendering Statements of Account*¹⁰³

As stated earlier, a third general duty owed by a banker to a customer is to render accounts periodically or on demand of the customer. Conversely, the common law has found that a customer owes at least two correlative duties; first, to take care in executing orders so as not to mislead the bank or facilitate forgeries, and secondly, to inform the bank of known or suspected forged instruments presented to or about to be presented to it. In addition, there is growing evidence that the common law requires two additional correlative duties of the customer in the context of rendering statements of account; first, to verify the accuracy of accounts even in the absence of account verification agreements, and secondly, to utilize reasonable accounting procedures so as to prevent forgeries.¹⁰⁴ These last two rules have received substantial support in recent years, in particular in *C.P. Hotels Ltd. v. Bank of Montreal*¹⁰⁵ in which the Ontario Court of Appeal upheld the closely reasoned decision of Montgomery J. in the High Court. Yet, in stark contrast to this expansive approach is that of the Privy Council in *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*¹⁰⁶ in which it overturned a decision of the Hong Kong Court of Appeal which took the same view of these matters as *C.P. Hotels*.

Both cases concerned disputes between the two innocent parties, the bank and the corporate employer of fraudulent clerks, as to which should bear the loss which arose after largely unsupervised clerks had forged

¹⁰² Manual of Inter-Bank Procedures and Standards, rule 5 of section A4, as cited, *supra*, footnote 95, at p. 475 (Ont. H.C.).

¹⁰³ This section is based on M.H. Ogilvie, *Bank Accounts and Obligations* (1986), 11 Can. Bus. L.J. 220.

¹⁰⁴ *Supra*, footnotes 18-22, for the case law.

¹⁰⁵ *Supra*, footnote 21.

¹⁰⁶ *Supra*, footnote 20 (P.C.), footnote 18 (Hong Kong C.A.).

cheques. In both cases the clerks had been responsible for reconciliations of bank statements, and the trial judges found, after hearing expert evidence, that the companies' systems of internal financial control were unsound and inadequate to the tasks of detecting and preventing fraud. Conversely, no negligence was found in the systems used by the banks for examining the signatures on cheques.

In both cases the fundamental question was whether the courts would expand the duties owed by customers to the bank from the first two as stated above to include the second two as stated above. Would the customers' duties with respect to bank statements be increased from those established at the beginning of this century?¹⁰⁷ In *C.P. Hotels* the Ontario courts found that a sophisticated commercial customer owes a duty to a bank to operate an internal control system so as to prevent or minimize losses occurring through forgeries.¹⁰⁸ Proper bank account reconciliation procedures are clearly required. Thus, the Ontario courts have opted to import the second two duties into the banker and customer relationship.

In contrast the Privy Council did not. Although the Hong Kong Court of Appeal, in an extremely well-researched and well-reasoned judgment, had found that the company owed not only duties to check statements of accounts and to operate proper internal accounting procedures, but also a general duty of care in contract and tort in the operation of bank accounts, the Privy Council decided to hold the law to the first two duties established at the beginning of this century. Lord Scarman clearly stated the policy as one requiring the banks to be insurers of companies which incur loss through the defalcations of their inadequately supervised clerks because banks can afford to be insurers!¹⁰⁹

In addition to the factual dubiety of this view and to its appropriateness as a policy of the law, the Privy Council's decision counters the traditional common law approach of mutuality in the obligation of banker and customer in the operation of banking accounts.¹¹⁰ Moreover, it actually encourages the confrontation of banker and customer in that Lord Scarman also suggests that if bankers really want such terms then they should lobby the legislature or incorporate them into their agreements!¹¹¹ Instead, the policy approach implicitly advocated by Montgomery J. is arguably preferable, since it acknowledges the trite reality that both banker

¹⁰⁷ *Supra*, footnote 48 for the case law.

¹⁰⁸ *Supra*, footnote 21, per Montgomery J. at pp. 533-534 (Ont. H.C.). Cf. two recent decisions in which *C.P. Hotels* was found not to be applicable: *J. & F. Transport Ltd. v. Markwart, supra*, footnote 3 and *Morguard Trust Co. v. Bank of Nova Scotia* (1982), 40 O.R. (2d) 211 (Ont. H.C.); (1983), 44 O.R. (2d) 384 (Ont. C.A.).

¹⁰⁹ *Supra*, footnote 20, at pp. 956-957.

¹¹⁰ As argued earlier in this paper.

¹¹¹ *Supra*, footnote 20, at p. 956.

and customer are required to play complementary and interrelated roles to ensure the proper operation of accounts. Such an approach is clearly within the spirit of the common law whereas the Privy Council's merely honours its letter.

It may be that the essence of the arguments of the respective banks in both *C.P. Hotels* and *Tai Hing* was that the customer ought to owe his bank a duty to take reasonable care in the conduct of all aspects of his account in the context of the banker and customer relationship. Such a duty might be implied in contract or imposed in tort. Conversely, such a general duty should also be expected of the banker and become the substantive content of the four broad duties already defined. To accept the banks' argument in these cases is simply to bring the banker and customer relationship into the mainstream of contemporary contract and tort law. It is merely the legal reflection of the modern nature of banking and of private obligation.

Conclusion

The obvious conclusion to be drawn from this re-examination of Canadian cases on the banker and customer relationship from the past decade or so is that there are significant indications that banking law is being brought into the fold of late twentieth century contract and tort law, as shown by judicial willingness to import a duty of reasonable care into contexts in which it never had existed before. A corollary is that the courts are doing so on both sides, as dictated by the circumstances under consideration; on the bank when collecting cheques and on the customer when reconciling bank statements. The courts are examining disputes afresh and not in the light of some negative predisposition, as might be expected in relation to an emotional topic such as banking, or in blind response to the patent one-sidedness of the standard form contracts in common use today, which may require curial re-evaluation in the future. Restoration of mutuality and complementarity of legal obligation in the banker and customer relationship can only benefit both parties for whose particular, selfish interests bank accounts exist in the first place.