THE TORT OF CONVERSION AND THE COLLECTING BANK: *TEVA CANADA LTD V BANK OF NOVA SCOTIA*

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The question of who should bear the loss when an employee defrauds an employer by means of cheques drawn on the employer's account has arisen frequently in banking law. Yet an answer which accords with the common sense that the employer and/or employee should do so eludes the Supreme Court of Canada, in contrast to that result in other common law jurisdictions. In a recent case, Teva Canada Ltd v Bank of Nova Scotia, the Court declined leave to appeal in a case which would have challenged the Court to reconsider Boma Manufacturing Ltd v CIBC and the vexed issues canvassed there of the meaning of sections 20(5) and 165(3) of the Bills of Exchange Act, and of the common law doctrines of estoppel by negligence, contributory negligence and vicarious liability. This paper sets out these legal issues and a possible resolution in the hope that the court will revisit this frequent fact paradigm in the future.

La question de savoir qui doit assumer les pertes lorsqu'un employé fraude un employeur au moyen de chèques tirés sur le compte de ce dernier s'est posée fréquemment dans le domaine du droit bancaire. Pourtant, une réponse faisant preuve de bon sens qui veut que l'employeur et/ou l'employé doive assumer cette perte n'est pas celle de la Cour suprême du Canada, contrairement aux conclusions prises par les tribunaux des autres pays de common law. Dans l'affaire récemment tranchée, Bank of Nova Scotia v. Teva Canada Limited, la Cour suprême a refusé l'autorisation d'appel dans une cause qui l'aurait menée à se pencher sur la décision rendue dans l'arrêt Boma Manufacturing Ltd. c Banque Canadienne Impériale de Commerce. Dans cette dernière affaire, les questions délicates suivantes avaient été examinées en profondeur: l'interprétation des paragraphes 20(5) et 165(3) de la Loi sur les lettres de change et les concepts de common law relatifs à la fin de non-recevoir fondée sur la négligence, la négligence contributive et la responsabilité du fait d'autrui. Le présent texte présente ces questions juridiques et envisage une façon de les résoudre dans l'espoir que la Cour réexaminera cet enjeu majeur dans un avenir rapproché.

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1. Introduction

The temptation to theft by employees from employers is a near universal phenomenon which not all employees are able to resist. For the most part, the economic value is small and can be built into the cost of doing business – a ballpoint pen or a glance at Facebook. However, in some workplaces, the economic value can be large, for example, where an employee is an unsupervised bookkeeper or accountant responsible both for the arrangement of payment by cheques *and* bank statement reconciliation. The number of cases where fraudulent employees forge cheques on an employer's account is large enough to suggest that a significant minority of employees succumb to the temptation. By the time the defalcation is uncovered by the employer, the funds have been dissipated and the employee is gone, so that the question becomes: Who should bear the loss?

The primary responsibility, *in fact*, for the fraud rests with the employer who has failed to provide either adequate accounting procedures or supervision for the employee so as to prevent fraud, or due diligence in employment of that person in the first place. A lay person unburdened by a knowledge of banking and payments law would likely so conclude. Not so in the law. Instead, the employer is offered two possible sources of reimbursement when cheques are involved, his own drawee bank on which the cheques were drawn, and the collecting bank into which the fraudulent employee deposited the cheques and which innocently sent them for collection to the drawee bank. An action against the drawee bank would sound in breach of contract, while an action against the collecting bank with whom neither the employer nor the drawee bank has a contractual relationship sounds in the tort of conversion but also draws in various provisions of the *Bills of Exchange Act* (*BEA*)[1] in relation to the legal nature of the cheque and the legal standing of the collecting bank in relation to the cheque.

An action against the drawee bank for breach of contract is based on the contractual duty of the drawee to its customer to return the funds placed on deposit in the account. The drawee is typically only released from this duty by the presence of clauses in the contract to that effect in certain expressly-stated instances, for example, by an account verification clause, setting out the customer's duties of supervision, reporting of losses immediately on their detection and reporting any other problems on receipt of an account statement within limited time periods. That is, the drawee is released where the wrongful removal of funds was due to some complicity on the part of the customer for which the verification clause provides a

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1 RSC 1985, c B-4.

shield and defence for the bank.[2] Whether a negligent customer is defeated by such a clause will, therefore, depend on how well the clause is drafted and how particular a court is in its construction. An action against a drawee bank by a customer in breach of contract might also be based on the implied duty of the bank to know its own customer's signature and to detect forged or unauthorized cheques (for example, the absence of a second signature where required). This duty continues notwithstanding automated cheque clearing and drawee banks are well within their rights both by virtue of their contact with a customer and the clearing rules to unwind a transaction when a forged or unauthorized signature is detected.[3]

By contrast, the collecting bank owes no contractual duty to the employer and has none of the protection afforded by a verification clause. It may innocently send the cheque for collection and then find an allegation of conversion in tort levelled against it. Section 48 of the BEA provides that a party who takes a forged cheque or forged endorsement from a fraudulent person bears the risk and while section 165(3) further provides that a collecting bank acquires all the rights and powers of a holder in due course, where the cheque is fraudulent, the collecting bank acquires no such rights but continues to bear the risk and associated loss. Moreover, in *Boma Manufacturing Ltd v Canadian Imperial Bank of Commerce*,[4] the Supreme Court of Canada further weakened the position of the innocent collecting bank when it limited the defence under section 20(5). Section 20(5) provides that a cheque payable to a fictitious or non-existing person may be treated as payable to bearer, so that the effect is to release the collecting bank only where the payee is fictitious or non-existing with the effect that many forged cheques may not be payable to bearer. The Court also limited the defences of a collecting bank in conversion when it insisted that because liability was strict, there can be no defence of contributory negligence. The net result is that the collecting bank, likely the most innocent of all the parties, remains liable in law when a fraudulent employee forges cheques on an employer's account – a position that is intuitively wrong to all except some Canadian appellate court judges!

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2 *Arrow Transfer Co v Royal Bank of Canada* (1972), 27 DLR (3d) 81 (SCC) [*Arrow*]; see also *No 10 Management v Royal Bank of Canada* (1976), 69 DLR (3d) 99 (Man CA).

3 For further analysis and support for these very broad statements about the bank and customer contract, see MH Ogilvie, *Bank and Customer Law in Canada*, 2nd ed (Toronto: Irwin Law, 2013) at chs 6-9 [Ogilvie, *Bank and Customer Law*].

4 (1996), 140 DLR (4th) 463 (SCC) [*Boma*].

In *Teva Canada Ltd v Bank of Nova Scotia*,[5] the Supreme Court of Canada had another opportunity to re-examine the issues raised by this fact paradigm, in particular, in relation to the tort of conversion. However, the Court declined leave to appeal without reasons. The purpose of this brief comment on the decision of the Ontario Court of Appeal is to use *Teva* to set out clearly the issues raised by this fact paradigm. The *Boma* decision, which was applied by the Court, has been subjected to unanimous scholarly condemnation,[6] yet lower courts do not attempt to distinguish it nor has the Supreme Court seen fit to review it. It is not the purpose of this paper to rehearse the voluminous case-law in this area,[7] but to set out clearly the legal issues so that a future court might consider redressing the morass into which the law has sunk.

2. Teva Very Briefly

Teva was concerned with an application by a collecting bank to amend its statement of defence to plead estoppel by negligence in a conversion action brought by an employer whose employees caused the employer to issue cheques to companies with names similar to customer names to the tune of about $4 million. Some 43 cheques were deposited in various accounts over a period of two years. The employer sued in conversion and the bank

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5 2012 ONCA 486, (2012), 294 OAC 323 [*Teva*]; leave to appeal to SCC denied, [2012] SCCA No 412 .

6 MH Ogilvie, "Should the Collecting Banker Be The Drawer's Insurer?: *Boma Manufacturing Ltd v Canadian Imperial Bank of Commerce*" (1994), 9 BFLR 227; Benjamin Geva, "Conversion of Unissued Cheques and the Fictitious or Non-Existing Payee-Boma v CIBC" (1997), 28 Can Bus LJ 177; Nicholas Rafferty and Jonnette Watson Hamilton, "Forged Payees' Endorsements: The Liability of Collecting Banks to Drawers and the Effect of Section 40(4) of the *Bills of Exchange Act*" (1998), 13 BFLR 271[Rafferty and Hamilton, "Forged Payees' Endorsements"]; Nicholas Rafferty and Jonnette Watson Hamilton,. "The Liability in Conversion of a Collecting Bank to the Payee: Is An Endorsement Required to Pass Title to a Cheque?" (2002), 17 BFLR 395 [Rafferty and Hamilton, "The Liability in Conversion"];Nicholas Rafferty and Jonnette Watson Hamilton. "The Collecting Bank's Liability for Conversion of Cheques" (2003),19 BFLR 77 [Rafferty and Hamilton, "Conversion of Cheques"]; Nicholas Rafferty and Jonnette Watson Hamilton, "Is the Collecting Bank now the Insurer of a Cheque's Drawer against Losses Caused by the Fraud of the Drawer's Own Employee?" (2005), 20 BFLR 427 [Rafferty and Hamilton, "The Collecting Bank"]; MH Ogilvie, "If *Boma* is Wrong, Is the Bank Always Right? *373409 Alberta Ltd v Bank of Montreal*" (2003), 39 Can Bus LJ 138; Munaf Mohamed and Jordan McJannet, "The Employer, the Bank, and the Fraudster: Vicarious Liability and *Boma Manufacturing Ltd v CIBC*" (2005), 20 BFLR 465. See also Bradley Crawford, *The Law of Banking and Payment in Canada* (Toronto: Canada Law Book, loose leaf) for criticisms of *Boma* throughout but especially in chs 10 and 22.

7 See Crawford, *ibid*, and Ogilvie, *Bank and Customer Law*, *supra* note 3 for analysis of this law.

countered that the cheques were not endorsed and that they were deposited in accounts in the payee's names.[8] Both the Master and the Divisional Court[9] refused to permit the employer to amend the statement of defence because the bank had not provided sufficient detail in support of estoppel. In the Divisional Court, the bank proposed to add pleadings that the employer knew about the fraudulent activity and breached a duty to prevent its continuation, and that it was negligent in failing to ensure that the cheques were properly drawn. The bank further pleaded that it relied detrimentally on the employer's failures. The Divisional Court dismissed the proposed amendments on the ground that they were "rooted in generality."[10] The Court further found that the proposed defence of estoppel by negligence was untenable because the tort of conversion is one of strict liability. In *Boma*, the Supreme Court of Canada held that contributory negligence is not available as a defence in conversion. Since estoppel by negligence is conceptually similar, the Divisional Court held it was also not available as a defence to a strict liability tort.

In the Ontario Court of Appeal, the bank characterized its proposed defence of estoppel by negligence as possessing four elements: (i) a duty of care owed by the representor to the representee; (ii) negligence in the performance of the duty; (iii) negligence causing the representee to believe certain facts; and (iv) negligence as the cause of the representee's loss.[11] The bank suggested that there was no legal precedent for this,[12] but that it was analogous to contributory negligence. It argued that the two-step test from *Anns v Merton London Borough Council*[13] should be used to decide whether a new duty of care should be established.[14] However, the Court unanimously rejected this position. It agreed with the Divisional Court that *Boma* was a complete answer to estoppel because there is no effective distinction from contributory negligence in this context.[15] The Court of

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8 The legal reasons for this response are unclear but this is what the Ontario CA reported, *supra* note 5 at para 3. The brief summary of the facts makes no reference to whether or not there were forged cheques. This issue would arise if a full trial had ensued and the trial judge made such fact findings. Since the case on appeal concerned solely amendment of the statement of defence to plead estoppel, nothing further can be said about the cheques. If the cheques were not forged the court should not have applied *Boma* which is about forged cheques.

9 2011 ONSC 6096. This citation is provided by the Court of Appeal, but the Divisional Court decision appears not to be reported anywhere.

10 *Supra* note 5 at para 9.

11 *Teva*, *supra* note 5 at para 12.

12 See *Arrow*, *supra* note 2.

13 [1977] UKHL 4.

14 The relationship of this to an estoppel argument is unclear other than that they are "sort of" the same!

15 *Teva, supra* note 5 at para 15.

Appeal agreed that conversion is a strict liability tort and that although estoppel is a separate legal concept, it required an assessment of the same facts.[16] The Court adopted the same policy justification as *Boma*, that as between certainty and a fair outcome, the law of negotiable instruments preferred certainty; the operation of an efficient banking market requires objective rules for the allocation of risk.[17] Apparently, the Supreme Court agreed.

Teva was concerned with an application for leave to amend pleadings only; the full evidence in the case was never heard and the facts determined. Yet the brisk fashion in which the courts disposed of the case may be a clue to how unwilling they are to revisit the issues relating to the liability of a collecting bank where there is employee fraud in relation to the drawee bank's customer. *Teva* was also concerned only with the tort of conversion and did not address the related *BEA* provisions which may have been relevant. The conceptual similarity of estoppel by negligence and contributory negligence may have doomed the collecting bank's case from the outset but the fact that the collecting bank made the estoppel argument as a potentially new way to review these cases suggests that there are significant issues in the fairness of the *Boma* approach to justify judicial review of the entire area.

3. Discussion

A) Tort of Conversion

In cases involving the paradigm of employee defalcation by use of cheques, there is a wide factual variety in relation to payees and signature of the cheques. The payees' names can be those of real people, similar to those of real people with whom the employer has had dealings, or entirely fictitious, that is, the names are not the names of existing people at all. The signatures can be valid, forged, or missing when more than one is required. The names of the payee accounts into which the cheques are deposited can be those of the payee or a name similar to a person with whom the employer has had business dealings or simply endorsed by the fraudulent person and transferred to a creditor of that person. Should any of this matter in the tort of conversion?

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16 *Ibid* at para 18.

17 *Ibid* at para 19. The Court then went on to cite LaForest J in *CP Hotels Ltd. v Bank of Montreal* [1987]1 SCR 711at para 21 in support of the priority of certainty over fairness. The Ontario Court of Appeal briefly flirted with the ideas of permitting negligence by a customer to preclude a claim by the customer, in *obiter dicta*, in *Royal Bank of Canada v Société Générale (Canada)* (2006), 219 OAC 83(CA).

In *Boma*, the Supreme Court confirmed that a drawer as the true owner of the cheque could sue the collecting bank in conversion when the collection was of a forged cheque.[18] The Court further found that the collecting bank had no defence of contributory negligence because conversion is a strict liability tort.[19] Nor did it have a defence in section 165(3) of the *BEA*; it was not a holder in due course because the bank did not take the cheques from a legitimate payee or endorsee, rather from a fraudulent person.[20] In addition, the Supreme Court found that section 20(5) did not apply because the cheques were payable to a real person and not a fictitious or non-existing person, so that they were not payable to bearer. Had they been payable to the bearer, a collecting bank which takes in good faith and for value would be a holder in due course and able to shelter behind section 165(3).[21]

In dissent, LaForest and McLachlin JJ agreed that section 165(3) did not protect a collecting bank in every circumstance, because the purpose of the section was to protect only where there is no endorsement or a restrictive endorsement. Since the dissenting position on section 20(5) was that almost all of the cheques were payable to fictitious or non-existing persons, however, they were payable to bearer and taken by the collecting bank in good faith and for value so that the bank was a holder in due course as defined by section 55 of the *BEA*.[22] LaForest J further found that as between the drawer/employer and the collecting bank, the employer was in the best position to prevent fraud; there was no duty of care in contract between the rightful owner of a cheque and a collecting bank, so that the more efficient allocation of risk to the employer is justifiable.[23]

Writing some sixteen years ago,[24] Benjamin Geva, whose views have found unanimous support from other commentators,[25] stated the conceptual difficulties with the Supreme Court's position on conversion which may be briefly summarized.[26] Since conversion is an action for the misappropriation of property available only to the person entitled to the possession of the property, conversion of a cheque is only available to the person entitled to the paper and the debt embodied thereon. A forged endorsement does not pass title pursuant to section 48(1) of the *BEA*, so that its true owner may sue in conversion; the claim to the cheque as a

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18 *Boma, supra* note 4 at para 37.

19 *Ibid* at para 30.

20 *Ibid* at paras 69-85.

21 *Ibid* at paras 91-106.

22 *Ibid.*

23 *Ibid* at paras 95, 103.

24 Geva, *supra* note 6.

25 See e.g. those sources cited *supra* note 6.

26 Geva, *supra* note 6 at 186-92, for what follows.

valuable chattel provides the basis for the action. But an unissued cheque is a mere piece of paper whose destruction, loss or misappropriation does not deprive the drawer of a valuable asset, so there is no basis for a conversion action against the collecting bank. Instead, the drawer has an action against the drawee bank in breach of contract for paying a cheque without a mandate as required by the bank and customer contract. The drawee may be able to recover the loss from the collecting bank by virtue of section 49(1) which provides that where a cheque is paid bearing a forged endorsement, the person by whom payment is made, may recover from the person to whom payment is made. Even in this situation, the drawee may have defences against the drawer, including estoppel, contributory negligence, or breach of an express term of the bank and customer agreement, such as a verification clause. In addition, the drawee may be able to plead section 20(5) by virtue of the cheque being payable to bearer where there is a fictitious or non-existing payee. The appropriate Supreme Court precedent for *Teva* was not *Boma* but *Arrow Transfer Co v Royal Bank of Canada*,[27] in which the Court found that to succeed in conversion, the plaintiff must be the true owner of the cheque, not a piece of paper, and that a plaintiff whose cheques were stolen and forged may be estopped by negligence so as to be liable for the loss rather than the drawee or collecting banks.

Geva's analysis is surely correct and it is regrettable that the courts in *Teva* did not take the opportunity to review the correctness of the *Boma* decision. Even if the action in conversion against the collecting bank was appropriate, however, there remains the issue of whether either contributory negligence or estoppel by negligence could have been invoked as defences by the collecting bank. In *Arrow*, the Supreme Court permitted a successful defence of estoppel by the collecting bank because an action in conversion could not succeed where the cheques were fraudulent as in that case.[28] For the same reason, there could be no action for money had and received on the basis of a waiver of tort because no tort had been committed.[29] Thus, the position is not as clear as the *Teva* courts suggested. Allen Linden and Bruce Feldthusen, in their definitive text on tort law,[30] note that in the context of strict liability generally, there is a growing view among tort scholars that there should be apportionment of loss in strict liability cases where appropriate.[31] They note that in *Rylands*

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27 *Supra* note 2.

28 *Ibid* at 87-88.

29 *Ibid* at 87.

30 Allan M Linden and Bruce Feldthusen, *Canadian Tort Law*, 8th ed. (Toronto: Lexis Nexis, 2006) at 545-47.

31 *Ibid* at 547.

v Fletcher[32] itself, the default of the plaintiff was recognized by the court as a defence and that this concept is similar to contributory negligence.[33] Other jurisdictions have expressly permitted a defence of contributory negligence in cheque conversion cases, including the UK,[34] Australia,[35] New Zealand,[36] and the US.[37]

In the absence of legislation, the argument for permitting a collecting bank to rely on defences of contributory negligence or estoppel by negligence remain strong. The very reason for the legislation was to ensure an equitable outcome based on factual liability for the loss in the first place. The reason is equally sustainable on a common law basis. There is no obvious reason why customers of a collecting bank should share a loss caused by the employer who is not a customer of that bank, yet that is the net result of *Boma*. Finally, there are two other possible ways in which the common law could be used to secure an equitable outcome which were not considered by the Supreme Court in *Boma*. The first is to impose vicarious liability on the employer for the defalcations of an employee as suggested by Mudaf Mohamed and Jordan McJannet.[38] and the second is to permit the collecting bank to take an assignment of the drawee bank's contractual rights for use against the employer in an action for breach of contract.

In short, on the conversion issue, *Teva* represents another missed opportunity to: (i) revise the legal bases on which the mistaken decision in *Boma* was based; (ii) redirect the attention of the courts to the employer/customer and drawee bank contract as the appropriate place for determining liability of defalcating customers; and (iii) review the defences for the collecting bank should actions in conversion be brought, including contributory negligence, estoppel by negligence, vicarious liability, and where available, reliance on an assignment of the drawee bank's rights.

B) Section 20(5)

Although section 20(5) of the *BEA* was not discussed at all in *Teva*, it is impossible to consider fully the conversion issues in these cases without

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32 (1866), LR 1 Ex 265 (HL) at 279.

33 Linden and Feldthusen, *supra* note 30 at 546.

34 *Banking Act 1979* (UK), c 37, s 47. For discussion, see EP Ellinger, E Lomnicka and CVM Hare, *Ellinger's Modern Banking Law*, 5th ed (Oxford: OUP, 2011) at 704-705.

35 *Bills of Exchange Act, 1909* (Cth), ss 88A, 88D.

36 *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 8.

37 UCC, Articles 3 and 4 (2002).

38 *Supra* note 6 at 470-71.

doing so. Section 20(5) provides that a cheque payable to a fictitious or non-existing person may be treated as payable to bearer, so that it may pass to a holder free of liability. A cheque payable to bearer also frees the drawee bank from liability to the customer and a collecting bank may rely on it as a defence because it innocently collects for the bearer when deposited in an account. In *Boma*, the majority of the Supreme Court found that the perspective from which to determine whether a payee is fictitious or non-existing is the guiding mind of the employer, that is, a court is required to find what was in the employer's mind as to the payee when the cheque was drawn. Thus, *Boma* narrowed the application of section 20(5) to cases involving corporate customers and employee thefts. However, in *Rouge Valley Health System v TD Canada Trust*,[39] the Ontario Court of Appeal seems to have distinguished *Boma*, in a case in which the fraudulent employee created cheques directing about $2 million to a company that existed in name only but had no operations. The Court decided that *Boma* did not apply because there was no evidence the signing officers had directed their minds to the payees and also that there was no relationship between the payee and the recipient company. Rather, the Court found that there was a systemic failure facilitating employee fraud and that the purpose of section 20(5) was to protect banks from fraud on the drawer such as that perpetrated by employees.[40]

In fact, this interpretation accords with the English case-law prior to the *BEA* as set out by Lord Herschell in *Bank of England v Vagliano Brothers*,[41] in relation to the defence of estoppel for drawers with knowledge of the fraud. In *Vagliano*, section 20(5) was extended to employee fraud generally. In *Boma*, LaForest J correctly understood that the purpose of section 20(5) was to protect banks and that the test as to whether the payee was fictitious or non-existing ought to be objective and not dependent on the subjective intention of anyone in the employer organization. Where an employee drew cheques to a payee who did not, from an objective perspective, exist, that action ought to be attributed to the employer, as the employee's principal, and the employer made liable for the resulting loss.[42] The collecting bank could rely on section 20(5) as a defence.[43]

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39 2012 ONCA 17, (2012), 108 OR (3d) 561 (Ont CA), aff'g 2010 ONSC 4717, [2010] OJ No 5302 (QL) [*Rouge Valley*].

40 *Ibid* at para 41.

41 [1891] AC 107 (HL) at 146-153 [*Vagliano*].

42 *Supra* note 4 at paras 100-101.

43 This approach would also eliminate the truly exasperating case law on the distinction, if any, between fictitious and non-existing; see Crawford, *supra* note 6 at 22-35 to 22-44.

By this test, the cheques at issue in *Teva* were payable to fictitious or non-existing payees since they were alleged to be payable to payees with similar but not identical names to the employer's customers; certainly, they were never intended to be paid to those actual customers. The cheques, therefore, were payable to bearer and the collecting bank free to collect them without incurring liability to the employer. This interpretation would not protect the employer from liability where the employer had failed to provide proper supervision, or even as alleged in *Teva*, had knowledge of the employees' conduct because section 20(5) is silent as to liability between employer and employee. As LaForest J observed in *Boma*, the law of agency would operate to attribute the conduct of the employee/agent to the employer/principal, so that the employer would bear the loss rather than the collecting bank. The drawee bank would, as suggested earlier, likely be protected by the verification clause in its contract with the employer, leaving the loss where it ought to be, if measured by fault, with the employer.

In short, had the Ontario Court of Appeal in *Teva* considered the section 20(5) defence available to the collecting bank and followed its earlier decision in *Rouge Valley* by distinguishing *Boma*, it would have permitted the collecting bank to rely on section 20(5) as an additional defence to contributory negligence, estoppel and vicarious liability.

C) Section 165(3)

The other potential defence which the collecting bank had in *Teva* was that it was a holder in due course pursuant to section 165(3) but again this issue was not addressed by the Court. In *Boma*, only the majority dealt with the meaning of section 165(3). The history of the section has been well-canvassed elsewhere,[44] and it is generally accepted that it was enacted to provide protection for a collecting bank by giving it the rights and powers of a holder in due course for any cheque deposited with it. *Prima facie*, the section provides very broad protection. In *Boma*, Iacobucci J opined that it was meant to protect banks where the bank did not get an endorsement from a customer on deposit but not where a third party cheque deposited is not endorsed, in which case, the risks of fraud may fall on a collecting bank.[45] The "person" in the section to which section 165(3) referred was restricted to a person entitled to the cheque, such as a payee or a legitimate endorsee. In *Boma*, that meant the provision was not a defence for the

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[44] Stephen A Scott, "The Bank is Always Right: Section 165(3) of the Bills of Exchange Act and its Curious Parliamentary History" (1973) 19 McGill LJ 78; Sheilah Martin, "Section 165(3) of the Bills of Exchange Act" (1985) 11 Can Bus LJ 23; Crawford, *supra* note 6 at 10-68.4 to 10-86.

[45] *Boma*, *supra* note 4 at paras 79-80.

collecting bank on a conversion action by the owner of the cheque because the payee was not entitled to the cheque. On the other hand, in *Teva* the question was whether cheques payable into accounts in the name of the payees on the cheques was sufficient to afford protection to the collecting bank. The answer must surely be yes because in that circumstance there is nothing to put the collecting bank on inquiry as to any irregularity in relation to the cheques. The collecting bank has acted in good faith in sending the cheques for collection without further issue. The absence of endorsements is irrelevant by virtue of section 165(3) which was enacted for this very reason according to *Boma*. Once more, liability for the loss is redirected to those most closely related to the defalcations, the employer and the drawee bank. In short, while the full facts of *Teva* will never be known, *prima facie*, the collecting bank could also have had a defence in section 165(3).

4. Conclusion

When employees commit fraud on their employers by means of cheques in workplaces where there is insufficient supervision or inadequate accounting procedures in place, the question of who should bear the loss, the employer, the drawee bank or the collecting bank, would normally be easily answered by a layperson: of course, the employer. In many jurisdictions, that would also be the legal answer.[46] That is not the answer in Canada, however. Top courts appear to have lost sight of what these cases are about, perhaps because they have been mesmerized by small factual distinctions in the means by which the defalcations have been executed, technical interpretations of the *BEA* somewhat distant from the original intentions of the draftsman, and possibly even too great a desire to ensure that a bank pays rather than a customer, notwithstanding that it will be the bank's other customers who will bear the loss caused by the fraud rather than the employer who was in the best position to prevent and to detect early any fraudulent conduct.

As stated at the outset, the purpose of this comment is not to review in detail all the case-law in this area but to set out clearly the essential legal issues for a future court willing to restore fairness and sanity to this small corner of banking law. To do so, a court may wish to use the following guidelines.

1. Since conversion as a tort is available only to a person entitled to possession of the property which has been misappropriated, where there is conversion of a cheque, by any means, only the person

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46 *Supra* notes 34-37.

entitled to the paper and the debt embodied thereon has a cause of action.

2. Where the cheque is unissued by the drawer, for example, an employer whose employee has dealt with the cheque in some fraudulent manner, the cheque is a mere piece of paper, so that the drawer is not deprived of a valuable asset and is not entitled to bring an action in conversion against the collecting bank.

3. The drawer may have an action for breach of contract against the drawee bank for honouring a cheque without a proper mandate but the drawee bank enjoys defences against its customer in estoppel, contributory negligence or in a contractual clause such as a verification clause, and in section 20(5) of the *BEA* by virtue of the cheque being payable to bearer.

4. Where the drawer sues the collecting bank in the tort of conversion, the collecting bank ought to have available the following defences: (i) estoppel by negligence; (ii) contributory negligence; (iii) vicarious liability; (iv) principal-agency; (v) section 20(5) by virtue of the cheques being payable to bearer where the named payee is fictitious or non-existing as objectively measured; and (vi) section 165(3) by virtue of becoming a holder in due course where there are no circumstances to put the bank on inquiry as to possible problems with the cheque.

Both Geva[47] and Crawford[48] have despaired of the courts restoring sense to this area of the law and have expressed the hope that Parliament will intervene to amend the *BEA* along the lines of other common law countries. But legislation to protect banks is likely to be politically too unpopular for any government to act, so that it seems more sensible to appeal to the courts to review the law. Plentiful resources exist in the scholarly literature, which is unanimous on the changes required to restore fairness and sanity to these not infrequent cases. But for the fact that these cases of employee defalcation involve cheques, the banks would never be involved and the loss would lie with the responsible parties, the employer or employee. Yet, it would be relatively simple for the courts to do what is required to restore fairness – in particular, to re-visit their interpretation of sections 20(5) and 165(3) and follow the lead of other common law courts in re-visiting the question of defences in the tort of conversion. This is, after all, how the common law has evolved naturally over the centuries!

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47 Benjamin Geva, "Forgery Losses: Banks Beware!" (2012) 31 Nat'l Banking L Rev 91 at 96.

48 *Supra* note 6 at 22-44.3.

Hopefully, the courts have not been entirely seduced by the spirit of the present age that it is always someone else's fault, especially someone with deep pockets. *Teva Canadian v Bank of Nova Scotia* represents a lost opportunity to rebut this possibility.