***Teva Canada v. Bank of Montreal:* 2017 SCC 51**

On October 27, 2017, the SCC rendered its decision in the case of ***Teva Canada v. BMO***. At stake was the future of the so-called "Fictitious Payee" defence (available to collecting banks) in cheque conversion cases. In a series of recent decisions, the Ontario Court of Appeal (CA) had been steadily strengthening this defence, and narrowing the scope of the SCC's 1996 decision in ***Boma Manufacturing v. CIBC*** [1996] 3 SCR 727. These recent decisions had made it much more difficult for victims of phoney vendor scams to recover in conversion claims from "collecting" banks (and credit unions). When the SCC granted leave to appeal in ***Teva***, the expectation of many was that the SCC would approve of this new bank-friendly direction. Instead, the SCC granted the appeal (in a 5:4 split decision) and reaffirmed its decision in ***Boma***. The implications are very important both for banks, and for those who might wish to sue them.

A phoney vendor scam can arise where a payables clerk fraudulently causes his employer to issue cheques to suppliers (either using real names, or made-up names) who are not owed anything. The clerk would then take the cheques, forge the payees' endorsements and deposit them to his own account or an account controlled by him. The victim of such a scam can sometimes recover the full amount of its losses from the so-called collecting bank, which accepted the stolen cheques for deposit, on the basis that the collecting bank "converted" such cheques.

A so-called "collecting bank" converts a cheque when it accepts for deposit a cheque which bears a legitimate drawer's signature, but which is deposited in an unauthorized fashion into the account of someone other than the payee. This situation can arise in the context of a phoney vendor scams, or, for example, in cases where a fraudster steals and negotiates a cheque made payable to someone else. Conversion is a strict liability tort, meaning that the due diligence of the collecting bank, or the negligence of the plaintiff, is no defence. However, s. 20(5) of ***The Bills of Exchange Act*** provides that where the cheque at issue is made payable to a "fictitious" or "non-existing" person, the bill may be treated by the collecting bank as if bore a legitimate endorsement so that the bank would take good title to the bill, and the claim for a conversion would fail. However, the law is clear that if the name of a real person is inserted as payee by way of mere pretence, with no "intention" that such person should receive the funds, then this would be a "fictitious payee". The key to the s. 20(5) defence is the intention of the drawer. In ***Boma***, the fraudulent bookkeeper convinced her employer to sign certain cheques to non-existent persons. The majority of the SCC held that while these payees were "non-existing" and "fictitious", the drawer was "reasonably mistaken" in believing that these payees were legitimate because the payee names were similar to the names of real suppliers. Thus, the SCC ruled that the Fictitious Payee defence did not apply in that case.

There has been a lot of criticism of the SCC's decision in ***Boma***, and there has been a steady effort on the part of the banks to scale back the scope of the decision. One complaint has been that the drawers of the cheques (account holders) are in a much better position than the collecting banks to prevent fraud so that it would be fairer and more efficient for the law to allocate the risk of such losses onto the drawers, and away from the banks. Another complaint is that the decision in ***Boma*** overlooked or ignored certain commercial realities in the manner in which cheques are generated in the business world and in particular, that the test in ***Boma*** attributed a positive intention to drawers in cases where no actual intention existed because the cheques were signed mechanically, in large cheque runs. The CA has been quite receptive to these arguments in recent years.

In its recent decision of ***Rouge Valley v. TD Canada Trust*** 2012 ONCA 17, the CA considered a phoney vendor scam in which the fraudster caused the plaintiff RV to issue cheques payable to phoney entities to which no debts were owed. The plaintiff argued, as per ***Boma***, that it had had a reasonable belief that the payees were legitimate. The CA disagreed, holding that the payees names bore no similarity to real suppliers, and that in any event, the plaintiff could not establish that it had had any *actual intent* in the creation of the cheques since they were created and signed mechanically. Thus, the Court held that no one responsible for running RV had actually considered the cheques at issue in any meaningful way, such that no one at RV could say that the cheques were being issued to a known entity. Accordingly, the s. 20(5) defence succeeded and the action was dismissed. In this decision, the CA effectively shifted the onus for demonstrating intent onto the drawer.

The facts were similar in ***Teva***: the fraudster employee requisitioned and then stole and negotiated a large number of cheques (for non-existent debts) that were payable to six entities, two of which were invented names - albeit names which were similar to actual vendor names - while four were legitimate customers; three of them current. In issuing the cheques, the company failed to follow its own internal procedures. Teva argued that the CA should infer that it had intended (however mistakenly) that the payees should receive the funds so that the s. 20(5) defence should not apply. The CA held the drawer could not demonstrate that it held an "honest, though mistaken, belief" since plaintiff (i) had not led any evidence to show that anyone in a position of authority had ever looked at the cheque reqs or the cheques themselves, and (ii) Teva had not followed its own internal procedures in the manner in which the cheque runs were prepared. Thus, the CA held that the plaintiff could not demonstrate that it had actually held any "reasonable belief" as to the payees.

In the ***Teva*** appeal, the majority of the SCC endorsed the approach set out in ***Boma,*** and in the earlier SCC decision in ***RBC v. Concrete Column Clamps*** [1977] 2 SCR 456. Among other things, the majority held that in the absence of a challenge to the validity of the cheques, it must be *presumed* that the drawer intended the payees to receive the proceeds. There is no need for the drawer to demonstrate *actual* intention, as was demanded by the CA. The SCC reaffirmed the ***Boma*** finding that a payee will be "non-existing" when the payee lacks an existing relationship with the drawer unless the drawer could "reasonably have mistaken" the payee (including a completely phoney payee name) to be one with such a relationship. This finding of a "reasonable belief" is not to be unlimited: it will not arise in the case of phoney names that are clearly outrageous, such as "Snow White", for example. It will now be up to the courts to decide where the line is drawn between "reasonable" and "unreasonable", although in ***Boma***, and in ***Teva***, the phoney payee names used by the fraudsters were similar to the names of real entities with which the drawer had done business.

This was a split decision which is unusual in Canada. The majority found that the decision in ***Boma*** was consistent with the long history of the common law in this country. The fact that there was frequent academic criticism of the ***Boma*** decision was not relevant, according to the majority. In any event, the majority found that fraud losses of the type at issue can bankrupt small companies, while banks have deep pockets and the ability to pay. When allocating risks between innocent parties, this factor was apparently the most important one to the majority.

Going forward, this is not quite open season on the banks: it may well be that a plaintiff in a phoney vendor scam will need to show that the phoney payee names were actually close in form to the names of real suppliers (although this point is sure to be litigated). Still, there is no question that this is a disappointing decision for the banks: any decision that is based in part upon the ability of one party to pay is not going to be favourable to the banks.

Reid Lester: October 31, 2017