

financial services litigation bulletin

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Supreme Court of Canada endorses bank's efforts to assist another bank in recovering fraud-related losses

The Supreme Court of Canada recently held that banks may, in certain circumstances, recover fraud-related losses from accounts of unwitting beneficiaries of a fraud and assist each other in such recovery efforts.

In the strange case of *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, the Supreme Court relied on the common law principle of mistake of fact in holding that the defendant, Bank of Nova Scotia ("BNS"), was entitled to debit funds from various accounts held by its client, B.M.P. National Distribution ("BMP"), in order to indemnify another bank, Royal Bank of Canada ("RBC"), for losses relating to payment on a counterfeit cheque. Canada's highest court sanctioned BNS' transfer of the funds from the fraudulent cheque back to RBC even though BNS had acted without its clients' consent in debiting their accounts.

facts

The facts of this case were peculiar to say the least. The plaintiff, BMP, was a company that distributed non-stick bakeware in British Columbia. Its owners claimed to have concluded an oral agreement whereby they sold distributorship rights in the United States for US\$1,200,000 to a "Mr. Newman", a stranger that they met at random and thought had a lot of potential because he dressed well.

After the deal was concluded, the principals of BMP received a cheque payable to BMP for \$904,563. The cheque was received in an envelope without a cover letter. The name on the envelope was that of an entity unknown to BMP. The cheque was written on the account of a drawer that was also unknown to BMP. In spite of these circumstances, BMP immediately assumed that the cheque was a down payment for the sale of distributorship rights. BMP deposited the cheque without endorsement into one of its accounts at BNS. BNS held payment on the cheque until it received confirmation that the cheque had cleared the payment process.

The funds credited to BMP's account, \$904,563 (the "Cheque Proceeds"), overwhelmingly surpassed its existing balance of \$56.97. The Cheque Proceeds

were quickly dispersed by BMP. Some of the funds were transferred to an account in New York City whose holder BMP said they did not know. The bulk of the Cheque Proceeds were transferred to personal accounts held by BMP's principals or a company controlled by one of its principals (the "Related Accounts").

The cheque was drawn on an RBC account. Soon afterwards, RBC notified BNS that the cheque was counterfeit and that the signatures of the drawers were forged and requested that BNS freeze BMP's accounts and return the Cheque Proceeds to RBC. BNS complied with RBC's request and reversed the credits applied to BMP's account and the Related Accounts. BNS also reversed certain bill payments from BMP's account to recover the Cheque Proceeds. Based on RBC's representation and warranty that the cheque at issue was counterfeit and that the Cheque Proceeds were proceeds of fraud, BNS transferred the amounts that it had recovered, \$777,336.04 (the "Retrieved Funds"), to RBC.

BMP commenced an action against BNS in which it sought to recover the Retrieved Funds as well as punitive and aggravated damages.

procedural history

Reaching what it admitted was an absurd result, the trial judge found that BNS breached its client service agreement with BMP by reversing funds already credited to its account, contrary to the cheque clearing rules of the Canadian Payments Association, which were held to have been incorporated into the service agreement. The judge ordered BNS to pay \$777,336 in pecuniary damages to compensate BMP for the total amount that BNS transferred to RBC. In his reasoning, the judge criticized BNS for favouring its business relationship with RBC to the detriment of its contractual obligations to its client.

On appeal, the British Columbia Court of Appeal reduced BMP's damages for breach of contract to nominal damages of \$1, plus \$100, an amount which BNS debited from BMP's account although it was not traceable to the Cheque Proceeds. Anchoring its verdict in equity, the court held that debits to BMP's account by BNS were appropriate and that BMP was trying to claim a windfall from the cheque fraud when, in fact, it had lost nothing. The appellate court admonished BMP for asking the courts to indirectly complete the attempted fraud.

However, the British Columbia appellate court held that BNS was not entitled to debit the Related Accounts in relation to the cheque fraud on that basis that the transfers of the Cheque Proceeds from BMP's account to the Related Account were legitimate and thus ought not to have been reversed.

the Supreme Court's decision

The Supreme Court held that BNS was permitted to debit BMP's account in light of RBC's right to restitution under the common law doctrine of mistake of fact. Under this doctrine, if money is paid by a bank through a mistake of fact, such as a mistaken belief that a

counterfeit cheque is legitimate, the bank is prima facie entitled to recover the money from the recipient of the funds. However, this presumption in favour of the bank would be defeated in the following circumstances:

- if the bank intended, or is deemed to have intended, that the payee keep the money;
- if the payment was made for good consideration; or
- if the payee had changed its position in good faith.

The Supreme Court held that none of these circumstances applied to preclude RBC's right to restitution. The Court noted that where a drawee bank provides funds to a collecting bank on the presentation of an instrument bearing a forged signature of the drawer of the cheque, the drawee bank will usually be in a position to assert that it did not intend the payee of the cheque to retain the funds. As RBC had mistakenly relied on a forged cheque in advancing the Cheque Proceeds to BNS, RBC could not have intended that BMP retain the Cheque Proceeds. Further, there was no evidence that BMP had changed its position or that it gave consideration for the Cheque Proceeds. The funds recovered by BNS and remitted to RBC were still in BMP's account or the Related Accounts.

The Court also held that BNS was entitled to debit the Related Accounts given that the funds debited by BNS were directly traced to the Cheque Proceeds. Tracing is permitted at law where a person has received money rightfully claimed by another person and the funds that have been received can be identified. As the funds transferred by BMP to the Related Accounts were clearly part of the Cheque Proceeds, RBC was entitled to such funds and tracing was permitted to recover them.

BMP tried to persuade the Court that it should retain the Cheque Proceeds by invoking a variety of justifications, including the need for finality of payment, the protection afforded under ss. 128(a) and 165(3) of the *Bills of Exchange Act* (the "BEA"), and the contractual obligations of a bank to its client, as embodied in BMP's service agreement with BNS.

The Court was unconvinced.

First, the Court held that while finality of payment is a laudable principle, it cannot negate rights to which a party would otherwise be entitled and, in particular, cannot be raised as an automatic bar to the recovery of a mistaken payment.

Second, the Court held that RBC could not be deemed at law to have intended that BMP retain the Cheque Proceeds under certain provisions of the BEA. The Court rejected BMP's attempt to rely on s. 128(a) of the BEA which provides that a bank that accepts a bill is precluded from denying the authenticity of the signature of the drawer of the bill to a "holder in due course". The Court noted that under the BEA, a payee must take a cheque for value to be a holder in due course. As BMP did not give value for the forged cheque, it was not a holder in due course and RBC was not precluded from denying the authenticity of the signature on the cheque to recover from BMP.

The Court also rejected BMP's argument that BNS was a holder in due course of the forged cheque by virtue of s. 165 of the BEA and, therefore, that RBC could not challenge the authenticity of the cheque to recover from BNS. The Court noted that s. 165 protects a bank from liability in relation to cheques deposited into its client's account. While BNS had this protection, it was not obligated to use it. It could still choose to waive such protection and respond to RBC's request for restitution in light of the fraud.

Finally, the Court held BNS would not be prohibited from returning the Cheque Proceeds to RBC under the terms of its account agreements with BMP. The account agreement set out certain circumstances in which BNS was entitled to debit BMP's account, including when cheques deposited into BMP's account did not clear through the payment process. The Supreme Court held that these provisions did not mean that BNS' ability to debit BMP's account was limited to such circumstances. Rather, the Court held that common law principles are implied terms of account agreements unless they conflict with the express terms of the agreement. The Court held that the common law principle allowing recovery of funds paid under a mistake of fact was an implied term of the account agreement. Canada's highest court also rejected the trial judge's holding that the clearing rules had been incorporated into the client service agreement and reaffirmed that cheque clearing rules apply only to members of the Canadian Payments Association and do not create rights in favour of third parties.

implications

The Court noted that the circumstances in which recovery will be allowed on the basis of payment under mistake of will likely be rare. In particular, banks will not be able to rely on this principle to recover fraud losses when:

- the recipient of the proceeds of the fraud has given consideration for the funds;
- the recipient of the proceeds of the fraud has, acting in good faith, changed its position upon coming into the funds; or
- the funds have been dispersed in a manner such that tracing is no longer possible.

However, this decision may still lend significant support to banks' efforts to recover fraud losses and to provide assistance to other financial institutions that have been victimized by fraud. First, the Court's resort to the principle of payment made under mistake of fact is significant given the scope of the doctrine. While the case related to a cheque fraud, the decision may be relied on by financial institutions to recover funds lost in relation to other forms of fraud that involve payment made on the basis of a false understanding of the true nature of a transaction, the identity of the individual with whom they are dealing or other material information.

The decision may also be relied on by banks in instances where there is insufficient evidence to tie the recipient of the proceeds of fraud to the fraud. It is not uncommon in fraudulent schemes for funds to be delivered to an individual who has no role or connection to

the fraudulent activities aside from collecting the proceeds of the fraud for subsequent distribution. This decision suggests that to recover the funds from such an individual, a bank need not prove the recipient's complicity in the fraud, but can recover the funds if it can prove that the funds are directly traceable to the funds paid on the basis of a mistake of fact. It will likely be difficult for individuals involved in the fraud to prove that they gave legitimate value for the funds so as to avoid the application of recovery on the basis of payment made on mistake of fact. However, a bank will have to move quickly after becoming aware of the fraud to recover the funds before the recipient of the funds or the collecting bank has changed its position as a result of receiving the funds and before the funds are dispersed to the point that they are no longer traceable.

Finally, the comments of the Court in reaching its decision are notable. The Supreme Court not only held in favour of BNS, but endorsed the Bank's efforts to assist RBC in recovering the Cheque Proceeds. The Court noted that "BNS acted in a way that could have enabled the parties to avoid going through a series of judicial proceedings." The Court further noted that BMP insisted on retaining the Cheque Proceeds even though it had given no consideration from them and that they were clearly the proceeds of a fraud. These comments suggest a reluctance on the part of courts, or at least Canada's highest court, to apply provisions of the BEA or other applicable law in narrow manner that would stymie efforts of victims of fraud to recover their losses and allow beneficiaries of a fraud to retain a windfall of tainted funds. They also suggest a reluctance to interfere with efforts of banks to cooperate to recover fraud losses without resort to litigation.

The decision may thus lend significant support to banks' efforts to fight fraud and recover losses.

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[a cautionary note](#)

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