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Teva: Employee Cheque Fraud - Who is Liable?

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Supreme Court of Canada rejects Fictitious or Non-Existing Payee Defence in finding Collecting Banks Liable for Employee Cheque Fraud

On October 27, 2017 the Supreme Court of Canada released its long-awaited decision in *Teva Canada Ltd. v. TD Canada Trust*. In a 5:4 decision, the Supreme Court held that two banks that accepted fraudulent cheques procured by a dishonest employee were strictly liable in conversion to the employer, and could not establish the "fictitious or non-existing payee" defence afforded by subsection 20(5) of the *Bills of Exchange Act*. The decision is a positive development for victims of fraud who seek to recover from banks in respect of certain types of employee cheque frauds. The Supreme Court reversed the decision of the Court of Appeal for Ontario, which had found that the payees were either fictitious or non-existing.

The Facts

Teva Canada Limited ("Teva") is a pharmaceutical company. McConachie was Teva's Finance Manager. McConachie implemented a fraudulent scheme whereby he prepared false cheque requisition forms for business entities with names that were similar or identical to those of Teva's real customers. Based on McConachie's fraudulent forms, Teva's accounts payable department issued the cheques and mechanically applied the requisite signatures.

The fraudulent cheques were made payable to payees with six different names. Two of those names, PCE Pharmacare and Pharma Team System, resembled the names of existing entities to whom no debt was owed: PCE Management Inc. and Pharma Systems. The four other names (Pharmachoice, London Drugs, Pharma Ed Advantage Inc. and Medical Pharmacies Group) were legitimate entities to whom no debt was owed.

McConachie registered the business names as sole proprietorships and opened bank accounts at several banks, including the Bank of Nova Scotia and TD Canada Trust (the "collecting

banks”). He then deposited 63 fraudulent cheques totalling $5,483,249 into these accounts and eventually removed the funds.

After discovering McConachie’s fraud and terminating him, Teva sued the collecting banks in conversion.

The Tort of Conversion and the *Bills of Exchange Act*

A collecting bank is *prima facie* liable in conversion where it transfers funds to an improper recipient, unless a statutory defence succeeds. As conversion is a strict liability tort, the bank’s negligence, or lack thereof, is irrelevant; any alleged contributory negligence on the part of the drawer is also irrelevant.

Here, Teva was the drawer of the cheques. The cheques were improperly obtained by McConachie and deposited to accounts held by him with the collecting banks. The collecting banks thereby dealt with the cheques under the direction of one not authorized, and made the proceeds available to someone other than the person rightfully entitled to possession. The collecting banks were therefore strictly liable to Teva in conversion, and would have to compensate Teva unless they could establish a statutory defence.

Before the Supreme Court, the collecting banks relied on the “fictitious payee” defence afforded by subsection 20(5) of the *Bills of Exchange Act*, which provides that:

Where the payee is a fictitious or non-existing person, the bill may be treated as payable to bearer.

This statutory defence renders a cheque payable to bearer, such that mere delivery, without endorsement, effects negotiation (the cheque would otherwise be payable to order, and would require an endorsement for negotiation).

The issue then became whether the payees were fictitious or non-existing. This analysis involves a two-step framework. The first step, which the majority characterized as the subjective fictitious payee inquiry, asks whether the drawer intended to pay the payee. If the collecting bank demonstrates that the drawer lacked such intent, then the payee is fictitious, the analysis ends and the bank’s defence succeeds. It is crucial to note, however, that “drawer intent” does not mean a specific intention to pay a payee in respect of any particular cheque; rather, the drawer’s intent to pay is presumed, unless the bank demonstrates otherwise.

If the bank does not prove that the drawer lacked such intent, then the payee is not fictitious, and the analysis proceeds to step two. This second step, which the majority characterized as the objective non-existing payee inquiry, asks whether the payee is either (1) a legitimate payee of the drawer; or (2) a payee who could reasonably be mistaken for a legitimate payee of the drawer. If neither of these is satisfied, then the payee does not exist, and the bank’s defence succeeds. If either is satisfied, then the payee exists, and the bank is liable.

The *Act* does not define the terms fictitious or non-existing, and it has been left to the courts to provide guidance. Canadian courts have generally followed the analytical framework provided by Falconbridge, which the majority quoted in full:

In the case of a bill drawn by [the drawer] upon [the drawee] payable to [the payee], the payee may or may not be fictitious or non-existing according to the circumstances:

(1) If [the payee] is not the name of any real person known to [the drawer], but is merely that of a creature of the imagination, the payee is non-existing and is probably also fictitious.

(2) If [the drawer] for some purpose of his own inserts as payee the name of [the payee], a real person who was known to him but whom he knows to be dead, the payee is non-existing, but is not fictitious.

(3) If [the payee] is the name of a real person known to [the drawer], but [the drawer] names him as payee by way of pretence, not intending that he should receive payment, the payee is fictitious, but is not non-existing.

(4) If [the payee] is the name of a real person, intended by [the drawer] to receive payment, the payee is neither fictitious nor non-existing, ***notwithstanding that [the drawer] has been induced to draw the bill by the fraud of some other person who has falsely represented to [the drawer] that there is a transaction in respect of which [the payee] is entitled to the sum mentioned in the bill****.* [emphasis added]

The Supreme Court's 1996 *Boma* decision modified the approach to non-existing payees slightly by finding that the payee was not non-existing in cases where the drawer could reasonably have mistaken a payee for a payee with an established relationship with the drawer. This involves an objective assessment. As a result, according to *Boma*, a payee will be non-existing when the payee lacks an established relationship with the drawer, unless the drawer could reasonably have mistaken the payee to be one with such a relationship.

Boma's narrowing of the ambit of non-existing payees becomes extremely significant where the fraudster has, as part of the fraud, caused his employer to issue cheques payable to an entity which has a name similar to, but not the same as, an existing creditor of the employer. It is not uncommon for a fraudster to set up a similarly-named entity to receive cheques, as the similar name deceives the employer and helps to conceal the fraud.

Where there is evidence that objectively establishes such a similarity, the bank's reliance on the defence can be defeated and the bank will be liable. In *Boma*, for example, cheques payable to "J. Lam" and "J.R. Lam" were found to be sufficiently similar to the name of a legitimate subcontractor, Van Sang Lam, to allow the Court to conclude that an intention to pay should be attributed. Thus, although "J. Lam" and "J.R. Lam" did not exist in reality, they were nevertheless not "non-existing" for the purposes of subsection 20(5), and the bank was liable.

Here, McConachie used the names of four actual entities that had dealings with Teva, and two entities that did not technically exist, but whose names were similar to entities with which Teva had legitimate dealings.

Applying the principles to the case at bar, the majority held that:

Though only four of the names used were those of existing customers, the other two names used were very similar to names of Teva's real customers. The motions judge found that there was "a rational basis for concluding that cheques were apparently made payable to existing clients", and that "the payees could plausibly be understood to be real entities and customers of the plaintiffs". As a result, the payees were not fictitious or non-existing.

Consequently, the collecting banks were liable to Teva.

Conclusion

Teva is a very significant decision for victims of fraud, as they are now better-positioned to look to banks as recovery targets in certain types of cheque losses. Where a dishonest employee has defrauded his employer through a cheque scam, it is imperative that the employer consider potential bank liability. This requires careful analysis, particularly with respect to whether the payee name is "sufficiently similar" to an existing entity with which the insured had legitimate prior dealings. Where the analysis demonstrates that a bank's reliance on subsection 20(5) of the *Act* is unfounded, a victim of cheque fraud may be able to obtain a significant recovery.

Teva Canada Ltd. v. TD Canada Trust, 2017 SCC 51

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