

A BANK, ITS CUSTOMER AND AN “EXTRA-LAYERED FRAUD”

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Recently, the British Columbia Court of Appeal considered the right of a bank’s customer to retain funds from a forged third-party cheque which was innocently deposited to its account. In *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia* the issue arose in the context of an action by account holders in which they sought to retain monies credited to a corporate bank account in the amount of \$904,563.

Bank A’s corporate customer deposited the cheque, drawn on Bank B, to its account. Upon the counterfeit cheque passing through the banking clearing system, Bank B paid the face value of the cheque to Bank A, which then advised its innocent corporate customer that the funds were available for use in its account at Bank A. At a time when no one knew that the third-party cheque was a forgery, a portion of these funds was then moved from that account to accounts that the innocent principals of the corporate account holder also held at Bank A. Upon Bank B subsequently discovering that the cheque was counterfeit, it informed Bank A, which then froze all of its customers’ accounts. Later Bank A debited those accounts and returned the monies to Bank B under an interbank arrangement.

The corporate account holder and its principals sued Bank A in B.C. Supreme Court to recover the funds debited from their accounts, alleging that the bank breached its duty to them as customers under the common law, the *Bills of Exchange Act*, the settlement rules of the Canadian Payments Association and their account agreements.

The trial judge found for the innocent account holders and awarded substantial damages. He held that Bank A, which was never exposed to any claims by Bank B by virtue of the interbank agreement, had acted in breach of its banking agreements with its customers when it reversed the credit in its customers’ accounts and remitted the funds derived from the forged third-party cheque to Bank B.

On appeal by Bank A, the Court of Appeal upheld the finding that the banking agreements had been breached but nevertheless allowed the bank’s appeal against its corporate customer. The Court of Appeal decided that the corporate account holder had not proved that it had actually suffered any damages as a result of its bank’s breaches. It was not deprived of anything which had any legally

recognized value because the forged cheque itself had no underlying value. Since it gained nothing by the deposit, the corporate customer lost nothing when Bank A debited its account. The Court of Appeal substituted a nominal damage award of \$101 in place of the Supreme Court's award of \$777,349.54 for breach of the corporate account holder's banking agreement with Bank A.

The Court of Appeal, however, dismissed the appeal by Bank A against the judgment in favour of the innocent principals of the corporate account holder, whose personal accounts were also debited. The Court of Appeal held that the cheques written on the corporate account holder's account and deposited to its principals' accounts at Bank A were valid as instruments according to the *Bills of Exchange Act*. When Bank A removed those funds from the principals' accounts and paid them to Bank B, it had breached the principals' banking agreements. Any remedies available to Bank A were held to lay in a "tracing, or an enquiry into the true ownership of the accounts", and not in the "self-help" approach taken by it.

The unusual facts and legal consequence of what the Court of Appeal termed an "extra-layered fraud" underscore the difficulties that financial institutions encounter in balancing their conflicting duties to their customers, themselves and others in cases of financial fraud. As this case serves to show, the rules of law and of equity can often collide in disputes between financial institutions and their customers, with results that may not be entirely foreseeable by the financial institution in responding to evidence of financial fraud.