

# Commercial Litigation Bulletin

April 2009

Fasken Martineau DuMoulin LLP

## Supreme Court of Canada Addresses Recovery of the Proceeds of Fraud

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### Overview

On April 2, 2009, the Supreme Court of Canada issued an important decision in *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, 2009 SCC 15, addressing whether a bank's customers could recover amounts debited from their accounts by their bank when it was discovered that the original source of the credits was a forged cheque.

The Court held that in the "strange" circumstances of this case, not only were the bank's customers not entitled to keep the proceeds of the forged cheque, but that on an application of common law principles, the bank could trace the funds into their various accounts and return the money to the victim of the fraud.

### Facts

The principals of the plaintiff B.M.P. Global Distribution Inc. ("BMP") claimed to have entered into an oral agreement for the right to distribute a line of non-stick bakeware in the United States. The price for the distribution rights of US\$1.2 million was arrived at by "pulling the number out of the air." The principals

of BMP entered the oral agreement with the ostensible purchaser of the distribution rights because he, "was a sharp-looking guy that seemed like he had a lot of potential" and he "dressed well".

Subsequently, BMP received a cheque payable to it for C\$904,563 (the "Cheque") drawn on the Royal Bank of Canada ("RBC") account of First National Financial Corporation ("First National"). The Cheque was enclosed in an envelope, without a cover letter, addressed from "E. Smith" located at 6-6855 Airport Road, Mississauga, Ontario.

The principals of BMP knew neither E. Smith, nor First National Financial Corporation. Nevertheless, they took the Cheque to The Bank of Nova Scotia ("Scotiabank") and deposited it in BMP's account which, prior to the deposit, held \$59.67. The manager of the Scotiabank branch placed a ten-day hold on the funds and contacted RBC to ensure there were sufficient funds in the First National account. Scotiabank received the funds from RBC in respect of the Cheque and, after the ten-day hold, permitted BMP access to the funds.

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BMP and its principals then made numerous payments and transfers, including a US\$20,000 wire transfer to a Citibank account held in New York by someone that the BMP principals said they did not know. They also transferred funds to the personal accounts of the BMP principals and to the account of a holding company of one of the principals.

Soon after, RBC discovered that the Cheque was a counterfeit bearing forged signatures. RBC requested Scotiabank's assistance in recovering the proceeds of the Cheque. Scotiabank froze the accounts of BMP and its principals and reversed certain bill payments. RBC and Scotiabank then entered into an agreement by which Scotiabank would transfer the proceeds of the fraud remaining in the various accounts back to RBC, and RBC would indemnify Scotiabank for any losses related to the restraint and transfer of the funds.

BMP brought a claim against Scotiabank for breach of contract, seeking damages equivalent to the proceeds of the Cheque which were restrained and returned to RBC.

At trial, the court awarded BMP the amount of the funds returned to RBC as damages. On appeal, the British Columbia Court of Appeal held it would be contrary to equity to permit BMP to retain the proceeds of fraud. However, the Court went on to hold that the funds that had been transferred from BMP to the accounts of its principals could not be interfered with by Scotiabank. The award of damages at trial for those amounts was upheld by the Court of Appeal.

## Outcome

The Supreme Court of Canada ("SCC") held that RBC had a right to recover the payments mistakenly made to BMP, and that BMP had no entitlement to keep the proceeds of the Cheque. The trial judge's ruling that BMP was entitled to

damages equivalent to the funds which had been returned to RBC was held to be wrong.

The SCC also held that at common law the proceeds of fraud could be traced into the accounts of the principals of BMP and returned to RBC. Consequently, the British Columbia Court of Appeal's decision to the contrary was set aside.

## Significant Findings

In its reasons for judgment, the SCC made a number of findings that are of great significance both to financial institutions and commercial litigants, generally.

The Court confirmed that a bank has a *prima facie* right to recover payments made under a mistake of fact, except where: (i) the payor intended the payee to have the money in any event; (ii) the payment was made for value; or (iii) the payee has changed position in good faith.

The SCC held that RBC had paid the amount of the Cheque to Scotiabank under the mistaken belief that the signatures on the Cheque were genuine. RBC therefore had a *prima facie* right to recover the payment made under a mistake of fact. None of the exceptions that could displace RBC's right to recover applied in the circumstances. On the facts, BMP had neither given value for the Cheque, nor changed its position as a result of the payment. Moreover, the law did not deem RBC to have intended BMP to have the money pursuant to any of the following: the principle of finality of payment; the provisions of the Bills of Exchange Act; the terms of the service agreement between the bank and its customers; or the clearing rules of the Canadian Payments Association.

The deposit of the forged Cheque, the Court held, could not result in a debt to BMP; and therefore, BMP did not lose anything when the credits were reversed. Consequently, the SCC

concluded that BMP had no entitlement to the funds, and there was no exception that barred RBC's right to recover based on the common law doctrine of mistake of fact. Therefore, Scotiabank had not acted improperly in returning the money to RBC.

The following findings are of particular significance to financial institutions:

1. Section 165(3) of the *Bills of Exchange Act* provides protection to a collecting bank as a holder in due course of even a forged cheque, but it does not oblige a bank to take that protection to refuse to repay funds to a victim of fraud.
2. The doctrine of mistake of fact (giving rise to a *prima facie* right to recover a mistaken payment) can be taken to be an implied term of an account agreement between the bank and its customers.
3. The clearing rules of the Canadian Payments Association are merely rules as between members; they do not create entitlements for third parties.

Of more general significance is the Court's discussion of the principles governing the common law doctrine of tracing. Tracing at law is permitted where a person has received money rightfully claimed by the claimant. Significantly, the court held that liability is based on receipt. Moreover, funds may be traced into bank accounts if, in the circumstances, it is possible to identify the particular funds at issue. Certification of a cheque is not a bar to tracing funds since

certification only guarantees initial payment; it does not bar a subsequent restitutionary claim.

### Implications

The Court's decision has confirmed the *prima facie* right of a financial institution to seek recovery of funds mistakenly paid out due to fraud. The judgment has also clarified the common law basis on which a victim of fraud may seek to recover funds mistakenly paid to a third party.

Consequently, the judgment provides financial institutions with greater certainty as to when they can seek and provide assistance to one another in recovering the proceeds of fraud: where funds have been paid by mistake as a result of fraud and none of the bars to recovery applies.

The decision also confirms the right at common law to trace funds, including in certain circumstances into bank accounts, where a person has received money that rightfully belongs to another. The common law principles of tracing have become more certain and more readily available to litigants.

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