

LOST AND STOLEN CHEQUES, BANK DRAFTS AND TRUST CHEQUES: SOME MODEST BUT PARTIAL SOLUTIONS

By Richard Olson and D. Ross McGowan

Cheques and bank drafts (referred to in this article as “items”¹) go missing from time to time either through theft, deliberate “loss”, carelessness or perhaps just bad luck. When this happens, the consequences can be significant.

When an item is lost, the drawer (in the case of a cheque) or the purchaser (in the case of a draft) will be exposed to a substantial potential liability if the item ends up in the hands of a dishonest person. Even if it remains lost, there is no simple process by which a lost draft or certified cheque can be “cancelled”, so it will remain outstanding. Imagine the consequences if one were lost on the way to a lawyer’s office to complete a multi-million-dollar deal. The item, even if truly lost, remains a contingent liability for a long time.

To understand how this arises requires a basic understanding of negotiable instruments.

NEGOTIABLE INSTRUMENTS: CHEQUES AND DRAFTS²

An item, as defined above, is a negotiable instrument. This refers only to the piece of paper. The underlying transaction is, for the most part, irrelevant. Once an item is put into circulation, the drawer or issuer loses control over it.

A cheque is a special type of bill of exchange. Its principle feature is that it is drawn on a “bank”³ as defined in the *Bills of Exchange Act*⁴ (“BEA”). There are three primary parties to a cheque:

1. the drawer (the person who issues the cheque);
2. the drawee (the bank on which it is drawn); and
3. the payee (the party to whom it is payable).

A bank draft is a similar instrument but has only two primary parties:

1. the bank (which is both drawer and drawee); and
2. the payee.

The payee (or subsequent holder) of a draft may treat it as either a cheque or a promissory note.⁵

A certified cheque is a cheque that has been "accepted" by the drawee bank and thus the bank has directly obligated itself to the payee, subject only to limited exceptions.⁶ A draft and a certified cheque today are treated in the same fashion. The bank transfers the amount of the item into a suspense account until the item is presented for payment.

Upon delivery of an item to the payee, the payee becomes a "holder" of the item. Generally a negotiable instrument can be endorsed by the payee to an endorsee who, upon receipt of the item in good faith and for value, usually becomes a "holder in due course" of the item. A "holder in due course" does not have an absolute right to payment, although it is often mistakenly thought that this is so. To qualify as a holder in due course, the person claiming must meet certain criteria:

55. (1) A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions, namely,

(a) that he became the holder of it before it was overdue and without notice that it had been previously dishonoured, if such was the fact; and

(b) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it.

(2) In particular, the title of a person who negotiates a bill is defective within the meaning of this Act when he obtained the bill, or the acceptance thereof, by fraud, duress or force and fear, or other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to a fraud.⁷

An item may be negotiated before it is due (such as a post-dated cheque) even though it is not payable until its due date. The original payee as a holder of the item is generally still subject to the equities arising from the underlying transaction. An endorsee, as a holder in due course, usually is not affected by the equities of the underlying transaction, subject to the criteria in s. 55.

The advantages of negotiable instruments have been demonstrated by their pervasive use for the past several centuries throughout the world, in commerce and for domestic purposes. However, every good thing has a dark side. Negotiable instruments are extremely difficult to countermand or stop once they have been put into circulation.

PROBLEMS

Cheques

A common and frequently fraudulent occurrence is the negotiation of an item through a cheque-cashing facility after the payee has claimed to lose

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it or after the drawer has stopped payment. The payee simply endorses the item to the cheque-cashing company and receives a discounted payment for it (the cheque-cashing company's profit or fee is the amount of the discount). The cheque-cashing company then presents the item for payment by depositing it in its bank account. If the item is a cheque that has been stopped, the cheque-cashing company, as a holder in due course, will almost always succeed in a claim on the cheque against the drawer.⁸ Exceptions do arise when the cheque-cashing company has, and ignores, reasonable suspicion as to any underlying defect in title that the payee or holder has with respect to the item.

This reality has startled many people who have stopped payment on a cheque, whether post-dated or not. The cheque may have been stopped because:

1. the payee failed to live up to a commitment; or
2. a replacement cheque had been issued after the original had been allegedly lost or destroyed.

An item that has been stolen or lost may also find its way into the hands of a fraudster who will try to profit from it in a number of different ways, such as:

1. endorsing it to a third party who then deposits it;
2. setting up an account in the name of the payee and depositing it; or
3. altering the name of the payee and using it in a transaction.

In the first case, the third party would have taken the item as a holder in due course, with the result that the drawer may be unable to assert a defence. In the second case, the drawer could either seek to return the item through the clearings, on the basis that the intended payee was not paid,⁹ or through advancement of a conversion claim against the fraudster. In the last case, the item would be void because of the alteration.¹⁰

Drafts and Certified Cheques

While the risk is relatively small, the consequences of losing a draft or a certified cheque can be significant. The loss is akin to losing cash or a gold bar.

A customer buys a draft,¹¹ and although the issuer has an obligation to replace it under the *BEA*,¹² it is only required to do so if an indemnity is given and appropriate security is provided. Neither a draft nor a certified cheque, in theory, has an expiry date, although as a practical matter either will become more difficult to collect as time goes by. Nevertheless, the amount of the item is retained in a suspense account, and this may last a

decade or more. There may be no practical way to recover the amount of the item during this period, as there is no provision in either the *BEA* or the *Bank Act* permitting cancellation of either. In fact, under the *Bank Act*,¹³ an outstanding draft or certified cheque is treated in the same way as an unclaimed deposit. If the item is not presented for payment after ten years, the amount must be paid to the Bank of Canada.¹⁴

Although a cheque becomes "stale dated" after six months, this is only a permissive rule of the Canadian Payments Association and does not oblige the return of older items. It is, in any event, inapplicable to certified cheques and drafts. Under the *BEA*, a cheque must be presented for payment within a "reasonable time".¹⁵ A reasonable time may be more than six months. Certification changes the status of the cheque, as mentioned above.

Lawyer's Trust Cheques

The same considerations apply to a lawyer's trust cheque. While usually not certified, a lawyer's trust cheque that goes missing can present a significant problem. If the cheque is stopped and a replacement issued, there is a possibility that the (fraudulent) payee may endorse the "lost" trust cheque to an innocent third party. If this happened, a lawyer would be liable on the cheque and the lawyer's trust account would be out of balance.

SOME POSSIBLE SOLUTIONS TO HEAD OFF PROBLEMS

The risk of putting an item into circulation and having it stolen or mislaid or dealt with fraudulently carries significant consequences, particularly where the item is a draft, a certified cheque or a lawyer's trust cheque. There is no ready means of replacement without risk.

The following are some solutions, although none of them is perfect:

1. issue a crossed cheque;
2. endorse the item with "For Deposit Only By Payee—Not Negotiable";
3. endorse the item with "Not payable more than X days after date"; or
4. wire transfer the funds.¹⁶

Crossing a cheque is a process that reduces, not entirely but significantly, the risks associated with a lost or stolen item. The *BEA* provides rules for issuing a crossed cheque, which is one that is not negotiable and may only be paid by a "bank". Crossed cheques do not appear to be used in Canada but are used elsewhere, particularly in the United Kingdom, where they are common. A crossed cheque may be certified if necessary.

To cross a cheque, "two parallel transverse lines" must be drawn across the face of the cheque.¹⁷ The words "not negotiable" may be added. A

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crossed cheque may also be "crossed specially" to a specific bank by the addition of the name of the bank between the lines.¹⁸ This further limits presenting the cheque for payment to the named bank. There are rules for banks to further cross specially a crossed or specially crossed cheque to obtain payment.

What are the advantages of crossing a cheque?

1. For a cheque that is not certified, it may only be presented by the payee for payment, so a stop payment order will be effective. This will provide comfort in replacing a cheque (providing the "lost" cheque was crossed) or in giving a post-dated cheque contingent on the payee fulfilling its obligations.
2. For a certified cheque, even though the payee has a claim directly against the certifying bank, that bank and the drawer may set up any defences to payment because the payee is a "holder", not a "holder in due course".

What a certified crossed cheque will not do is allow the release of the funds held in the suspense account, but it may provide the basis for negotiating a less onerous security agreement.

One word of caution should be added with respect to the use of crossed cheques. It is not a panacea to cure all fraud. Ingenious fraudsters may still seek to direct payment from a crossed cheque to their particular benefit to an account of their choosing with the payee bank.

A second problem is that, even though contemplated by the *BEA*, no provision has been made for their use by the Canadian Payments Association, and it is possible that the automated cheque processing and clearing system will not handle them. This means that they would need to be handled manually.

Endorsing an item "For Deposit Only By Payee—Not Negotiable" is an alternative to crossing a cheque. The *BEA* provides for limiting or prohibiting the negotiability of a bill of exchange.¹⁹ It is still valid between the parties, but it is not negotiable.²⁰

Endorsing the item "Not payable more than X days after date" is an additional safeguard that is available but is seldom used. Under the *BEA*, a bill of exchange (which includes a cheque) must be presented for payment within a "reasonable time". In determining what is a reasonable time,

regard shall be had to the nature of the bill, the usage of trade with respect to similar bills and the facts of the particular case.²¹

In the case of a cheque, the *BEA* also provides:

166. (1) Subject to this Act,

(a) where a cheque is not presented for payment within a reasonable time of its issue and the drawer or the person on whose account it is drawn had the right at the time of presentment, as between him and the bank, to have the cheque paid, and suffers actual damage through the delay, he is discharged to the extent of the damage, that is to say, to the extent to which the drawer or person is a creditor of the bank to a larger amount than he would have been had the cheque been paid; and

(b) the holder of the cheque, with respect to which the drawer or person is discharged, shall be a creditor, in lieu of the drawer or person, of the bank to the extent of the discharge, and entitled to recover the amount from it.

(2) In determining what is a reasonable time, within this section, regard shall be had to the nature of the instrument, the usage of trade and of banks and the facts of the particular case.

It is no easy task to determine when a cheque (other than a certified cheque or a draft) is no longer payable by reason of delay in presenting it for payment. The addition of a limitation to the date of payment does not seem to contravene any section of the *BEA* and would be a useful feature of both cheques and certified cheques and drafts.

The vast majority of items used legitimately are processed within a short time after issuance. Providing a "best before date" for an item is a useful safeguard in the event that it disappears and needs to be replaced. It would be even better if this were routinely printed on cheques.

The last option, wire transfer, has one cardinal advantage for the payer: as long as the instructions are accurate, if the funds go astray, subject to express contractual language to the contrary, it is the bank that is at risk, although it may still take some time to sort out.²² It should be noted that service charges are sometimes deducted from wire transfer amounts.

SOME POSSIBLE SOLUTIONS IF THE ITEM IS LOST OR STOLEN

In a recent decision, *Esse v. Bank of Montreal*,²³ the Ontario Court of Appeal set aside a summary judgment that had been granted in favour of the payee of three certified cheques drawn on the Bank of Montreal ("BMO") that, it was argued, were the proceeds of a fraud. Although this decision does not involve a lost item, it does examine critically the nature of a certified cheque and the status of "holder in due course". These issues are important for the strategy suggested below.

The series of transactions at issue included an underlying mortgage fraud, transactions with imposters, and a bag full of cash.²⁴ Three USD cheques were drawn by one party on its BMO account and, at the direction of a second party, were made payable to a third party (Esse, using the alias "S. Asis"). The cheques were then certified by BMO, held by the Esse/Asis for four months and deposited by him to an account at Bank Leumi in Toronto for transfer to Luxembourg. After receiving the cheques for pay-

ment, BMO stated. Esse then sued. The certification of the cheques rendered the bank liable on the face value of the cheques (I) in the event of a defect in the title.

A summary judgment was granted on the face value of the cheques. The case involved issues of certification that would have been avoided by the cheques (I) in the event of a defect in the title.

The Ontario Court of Appeal directed the issuance of a certification of the cheques to defend on the bank and that the payment of the cheques was a question of fact. The court shed light on the issue.

This decision is a landmark on certified cheques as being tantamount to cash. It should not be a surprise. *Esse* also challenges to the bank's strategy. The court's decision is unanswered, a burden to the payer and free from the bank. It also be returned to the payee or another party.

As there are many solutions suggested for drafts or certified cheques, given the fact that the item is void and "returned" to the payer or a holder in due course. The solutions suggested are significantly reduced.

CONCLUSION

There is always a way to recover funds by a negotiable instrument.

ment, BMO stopped payment and the credit at Bank Leumi was reversed. Esse then sued BMO, asserting that he was a holder in due course and that the certification meant that BMO had accepted the cheques and was therefore liable on them to him.

A summary judgment motion by the payee was allowed against BMO for the face value of the cheques. BMO appealed and asserted that the matter involved issues of credibility and that Esse had failed to disclose evidence that would have brought into question whether the payee truly took the cheques (1) in good faith; (2) for value and (3) without notice of any defect in the title of the person who negotiated them.

The Ontario Court of Appeal overturned the summary judgment and directed the issues to be heard at trial. In doing so, the court noted that the certification of the cheques amounted to acceptance but that BMO could defend on the basis that the payee could not claim as a holder in due course and that the payee could not thwart the process by refusing to answer obvious questions or refusing production of necessary documents that would shed light on the issue of the payee's knowledge of defect in title.

This decision confirms that defences are available to claims for payment on certified cheques. Certified cheques are sometimes inaccurately viewed as being tantamount to cash. The *Esse* decision suggests that they perhaps should not be afforded such a lofty status by either the drawee or the recipients. *Esse* also confirms that certification of a cheque does not preclude all challenges to the transaction by the certifying bank and that with appropriate strategic questioning and document discovery requests that go unanswered, a court can draw an adverse inference sufficient to shift the onus to the payee to establish receipt of the cheque in good faith, for value and free from notice of any defect in title. Similarly, a certified cheque may also be returned and not honoured on the basis of a forged endorsement of the payee or any material alteration after certification.

As there are no provisions in the *BEA* to provide for the cancellation of drafts or certified cheques when they are lost or stolen, it may well be possible, given the analysis in *Esse*, to seek a declaration that the lost or stolen item is void and that no title can pass because the item was never "delivered" to the payee and thus no person could ever claim to be either a holder or a holder in due course. Of course, by adopting some of the preventative solutions suggested above, these difficulties could be eliminated or at least significantly reduced.

CONCLUSION

There is always risk in carrying out any transaction, but the transfer of funds by a negotiable instrument has, lurking in the background, a horri-

ble potential to go wrong. It does not happen often, but when it does the consequences can be ugly. The proposals in this article offer some additional protections that should be considered and a strategy to follow if things have gone wrong.

ENDNOTES

1. "Item" is the term used in the Canadian Payments Association Rules for instruments sent through the clearing system.
2. This account is necessarily a summary; for a broader overview, see Richard Olson, "Bills of Exchange and Banking Instruments", in *Banking Basics*, CLE 2003, or for a more comprehensive discussion, see Bradley Crawford, *Payment, Clearing and Settlement in Canada* (Aurora, ON: Canada Law Book, 2002); and Benjamin Geva, "The Autonomy of the Banker's Obligation on Bank Drafts and Certified Cheques" (1994) 73 *Can. Bar Rev.* 21.
3. A "bank" is defined in the *Bills of Exchange Act*, R.S.C. 1985, c. B-4, s. 2, as a member of the Canadian Payments Association and includes almost all banks, trust companies and credit unions in Canada. "Cheques" drawn on banks outside of Canada are *not* "cheques" under the *BEA*; they are "foreign bills": see the *BEA*, s. 24 (2).
4. R.S.C. 1985, c. B-4.
5. *BEA*, *supra* note 3 at s. 25.
6. *Centrac Inc. v. CIBC* (1994), 20 O.R. (3d) 105 (Gen. Div.); *aff'd* (1994), 21 O.R. (3d) 161 (C.A.); and *A.E. Lepage v. Rattray* (1994), 21 O.R. (3d) 164.
7. *BEA*, *supra* note 3 at s. 55.
8. *National Money Mart Co. v. Sidhu*, 2006 ABPC 233 (Can LII); *Wheatland Investments Ltd. v. Sask Tel*, [1995] 1 W.W.R. 671 (Sask. Q.B.).
9. See Canadian Payment Association Clearing Rules, A4, para. (b).
10. *Franklin Traffic Service Inc. v. CIBC and HSBC*, 2008 CanLII 51472 (Ont. S.C.).
11. The payee (or endorsee) of a draft (which is drawn by a bank on itself) may treat the draft as either a promissory note or a bill of exchange: *BEA*, *supra* note 3 at s. 25.
12. See *BEA*, *supra* note 3 at ss. 155 and 156.
13. S.C. 1991, c. 46.
14. *Bank Act*, S.C. 1991, c. 46, s. 438 (1) (b).
15. *BEA*, *supra* note 3 at s. 166.
16. Wire transfers may not be permissible for most transactions from lawyers' trust accounts. See, for instance, Law Society of British Columbia Rule 3-56 (1.3).
17. *BEA*, *supra* note 3 at s. 168 (1).
18. *Ibid.*, s. 168(2).
19. *Ibid.*, s. 20(1).
20. *Ibid.*, s. 20(1).
21. *Ibid.*, s. 85.
22. Wire transfers may not be permissible for most transactions from lawyers' trust accounts. See, for instance, Law Society of British Columbia Rule 3-56 (1.3).
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