Reflections on the Need to Revise the Bills of Exchange Act—Some Doctrinal Aspects

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REFLECTIONS ON THE NEED TO REVISE THE BILLS OF EXCHANGE ACT*

PANEL DISCUSSION

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Reflections on the Need to Revise the Bills of Exchange Act — Some Doctrinal Aspects

Benjamin Geva†

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Introduction

It has been said of the United Kingdom Bills of Exchange Act,

† Associate Professor of Law, Osgoode Hall Law School, York University. Copyright © 1981, by Benjamin Geva. I gratefully acknowledge the assistance of Ms. Ann Wilson, consulting assistant editor of the Journal, in the revision of this paper.
1882\(^1\) that it is "the best drafted Act of Parliament ever passed".\(^2\)

The Act has been adopted in many countries of the Commonwealth,\(^3\) including Canada,\(^4\) and has contributed to certainty and uniformity in an important branch of commercial law.

The approaching centennial anniversary of the statute provides an excellent occasion for re-evaluation and re-examination. Only a year after the passage of the statute, its drafter confessed that he "could do it better and should profit by past experience".\(^5\) While it is overwhelmingly accepted that the Act succeeded in codifying the rules applicable to bills and notes\(^6\) as well as in providing for a statutory machinery which has so far been viable, there are some areas which require improvement. Reflections on such areas are the subject-matter of this paper.

The paper discusses three areas in which the interaction between the provisions of the Act and case law has failed to provide satisfactory results. Part I deals with holder in due course issues: conditions for holding in due course, results of holding in due course, and the payee as a holder in due course. Part II deals with the drawee bank's right to recover on cheques paid by mistake of fact. Part III deals with the responsiveness to policy considerations of the scheme allocating forgery losses. I chose not to deal in this paper with questions of strict statutory interpretation not involving an issue with a substantial doctrinal or policy flavour, as for example, liability on an instrument signed in a representative capacity.\(^7\) Likewise, I excluded from the paper

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1 45-46 Vict., c. 61 as amended.
4 The Bills of Exchange Act, R.S.C. 1970, c. B-5 as amended (hereafter "BEA", "the Act" or "the Canadian Act"). For a short account of the history of the Act in the United Kingdom and Canada see Falconbridge, \textit{The Law of Negotiable Instruments in Canada} (1967), p. 2. For the special features of the Canadian statute see Falconbridge, \textit{supra}, footnote 3 at p. 427. Unless otherwise indicated, references to sections in this paper are to the sections of the Canadian Act.
6 The codifying nature of the BEA is highlighted in \textit{Bank of England v. Vagliano Bros.}, [1891] A.C. 107 (H.L.), at pp. 144-5. Undoubtedly, the limits on the applicability of pre-Act common law rules contributed much to uniformity among BEA jurisdictions.
7 On this question (relating to s. 52), see \textit{Glatt v. Rit}, [1973] 2 O.R. 447 at pp. 454-5, 34
issues discussed by me at length elsewhere, such as the rights of one not holder in due course, or more particularly, his position regarding the defences of failure and absence of consideration. Another subject falling within this excluded category is that of consumer bills and notes covered by Part V of the Act which I have dealt with only briefly in this paper. Other areas were excluded due to space limitations. Thus, I did not deal with the issues of the scope of the Act, namely the definition of the various negotiable instruments covered by it, the applicability of the Act to negotiable instruments issued or drawn by banks, and the principles governing the interaction between the provisions of the Act and general principles of law. I also did not deal with issues relating to the transfer and negotiation of a bill or note, material alteration, and the effect of payment by bill or note on the obligation for which it is given. Questions relating to collection of cheques are omitted as well, as they would better be dealt with as part of a comprehensive discussion on the Canadian payment system.

I. Holder in Due Course Issues

One who holds an instrument “free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves” and who “may enforce payment against all parties liable on the [instrument]” (s. 74(b)) is called a “holder in due course”. His position constitutes an important exception to the nemo dat quod non habet rule. It is explained by the currency of negotiable instruments and is central to the law


For an analysis of the last question see my article cited in footnote 9, supra.


See, e.g., Stanley Goldstein’s study for the federal government on Changing Times: Banking in the Electronic Age (Ottawa, 1979).

governing them. Current issues with respect to his position are: (i) the conditions for holding in due course; (ii) the results of holding in due course; and (iii) whether a payee may be a holder in due course. The last issue is in fact one aspect of the first, but due to the length of the pertinent discussion, I have chosen to deal with it separately.

(i) Conditions for holding in due course

At common law, in order to acquire a holder in due course status, it was sufficient to purchase an instrument _bona fide_ and for value.\textsuperscript{14} Under the Act a person must comply with eight separate and independent conditions specified in s. 56(1):

1. he must be a “holder” (defined in s. 2) of an instrument;
2. the instrument must be complete and regular on the face of it;
3. he must have become the holder before the instrument was overdue;
4. he must have taken the instrument without notice that it had been previously dishonoured; and
5. he must have taken the instrument in good faith,
6. for value,
7. by negotiation, and
8. without notice of any defect in the title of the person who negotiated it.

“Holder” is defined in s. 2 as “the payee or endorsee of a bill or note who is in possession of it, or the bearer thereof.” According to Chalmers, the term “signifies the mercantile owner of the instrument”.\textsuperscript{15} Since a holder in due course must be a “holder”, a transferee of an unendorsed instrument payable to order does not acquire a holder in due course status. Such a transferee for value acquires the transferor’s rights as well as “the right to have the endorsement of the transferor” (s. 61(1)); but to become a holder in due course, such a transferee must obtain his transferor’s endorsement while still complying with the other elements of s. 56(1). Thus, notice of a defect in his transferor’s title, acquired after the good faith purchase of the instrument but prior to

\textsuperscript{14} Miller v. Race, supra.
obtaining endorsement, will prevent the transferee from becoming a holder in due course.16

The requirement that a holder in due course must acquire the instrument "by negotiation" will be discussed below (section iii) in connection with the issue of the payee as a holder in due course.

Besides the "holder" and "by negotiation" elements, all of the holding in due course requirements are concerned with the good faith purchase for valuable of the instrument.

"Value" under s. 2 is "value consideration". Under s. 53(1):

1. Valuable consideration ... may be constituted by
   a. any consideration sufficient to support a simple contract;
   b. an antecedent debt or liability.

Subsection (1)(a) has been construed as referring to the general law of the province, and not necessarily to the common law of England.17 This construction which has particular significance for Quebec undermines uniformity.18 Yet local variations in matters not relating to "the law of bills and notes in the strict sense"19 are tolerated by the Act.20 Furthermore, in commercial transactions the consideration requirement creates very little (or almost no) difficulty. As a result I do not think that the statute should be amended to refer particularly to common law consideration.

"An antecedent debt or liability" under s. 53(1)(b) means that the promissor's own pre-existing debt is a valid consideration for a negotiable instrument. This departure from the common law rule, under which past consideration is no consideration, is not limited to the law of bills and notes. Rather it is consistent with the general exception under which a promise to pay the promissor's own debt requires no consideration.21

Does "executory consideration" (e.g., a promise to pay at a

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18 Cf. Falconbridge, supra, footnote 3 at pp. 606-7.
19 For this concept see Falconbridge, ibid., at p. 456, and in more detail, Barak, "The Requirement of Consideration for Bills and Notes in Israel", 2 Israel L. Rev. 499 (1967), at p. 500.
20 See, e.g., s. 47(1):
   (1) Capacity to incur liability as a party to a bill is coextensive with capacity to contract.
   This is a direct reference to the various provincial laws governing capacity.
21 Falconbridge, supra, footnote 3 at pp. 610-11.
future date) constitute value for holding in due course purposes? The drafters of the American Uniform Commercial Code adopted a negative answer in UCC 3-303(a). In the Comment they gave the following "reason of policy":

... when the purchaser learns of a defense against the instrument or of a defect in the title he is not required to enforce the instrument, but is free to rescind the transaction ... There is thus not the same necessity for giving him the status of a holder in due course, cutting off claims and defenses, as where he has actually paid value.

At the same time, executory consideration seems to fall within the ambit of "any consideration sufficient to support a simple contract" within the meaning of s. 53(1)(a). Moreover, under s. 165(3), merely crediting a customer’s account with the amount of a deposited cheque constitutes sufficient "value" for holding in due course purposes. Such credit is undoubtedly "executory consideration"; in fact the opinion of the drafters of the Code is that bank credit not drawn upon, which can be and is revoked when a claim or defence appears, is the example par excellence of an executory consideration which therefore, under the UCC, does not constitute value for holding in due course purposes.

This suggests that the Act rejects the policy adopted by the drafters of the Code. The rule in the Act is that giving an executory consideration constitutes taking for value for the purpose of s. 56(1)(b). Provided he meets the other conditions in s. 56(1), a holder who acquires an instrument, undertaking to pay for it at a future time, is a holder in due course. His status is not defeated by knowledge of a defect of title acquired after his purchase and undertaking to pay but prior to his payment. It is submitted that the reversal of this result can effectively be brought about only by legislative action.

The treatment in the Act of the question of the "good faith purchase" appears to be somewhat flawed:

(a) While the Act refers in s. 56(1) to "without notice" separately from "good faith", the former is actually one element of the latter; and

(b) The requirements that the instrument must be "complete and regular on the face of it" and that it must not be

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22 The provision is cited in full in the text between footnotes 40-1, infra.

23 It could constitute "value" also under the law preceding the enactment of s. 165(3): Falconbridge, supra, footnote 3 at p. 615.

24 Official Comment 3 to UCC 3-303. See also UCC 4-208 and 4-209.
overdue, both have to do with the holder's good faith. At the same time, the effect of their being listed as separate and independent requirements is to create an irrebuttable presumption as to the holder's lack of good faith once either of them is not fulfilled. The advantage of such treatment is certainty.\textsuperscript{25} The shortcoming is obvious: a \textit{bona fide} holder who, for whatever reason, failed to notice that he acquired an overdue instrument, may not be a holder in due course.

At common law the standard of good faith for holding in due course purposes has been transformed from an objective to a subjective one.\textsuperscript{26} The latter was adopted by the Act. "Good faith" in other words, requires honesty alone; one could act negligently and still be acting in good faith (s. 3). Likewise, "notice"\textsuperscript{2} is actual notice. Good faith is, none the less, defeated by one's suspicion combined with a wilful disregard of the means of knowledge, as when the circumstances invite inquiry.\textsuperscript{27} In relation to defences arising from a contract under which a negotiable instrument has been given, neither mere suspicion of the existence of defences, nor mere knowledge of the terms of the contract which are capable of giving rise to defences defeats the holder's good faith.

The effect of this subjective standard is to withdraw the onus of inquiry from the taker of a negotiable instrument. This is consistent with the function of the holder in due course doctrine which is to facilitate the currency quality of negotiable instruments. Generally speaking, the courts have been quite effective in implementing this policy through the good faith standard and no statutory revision seems to be required.

The only exception lies in the case of a close business relationship between the payee of an instrument, typically a seller of consumer goods, and the subsequent holder, typically a financing institution. Quite frequently, the subsequent holder meets the subjective test of good faith, but it has been felt that due to his intimate and close business relationship with the payee, he does not deserve the elevated position of a holder in due

\textsuperscript{25} See, \textit{e.g.}, Barak, "The Uniform Commercial Code — Commercial Paper, An Outsider's View, Part I", 3 Israel L. Rev. 7 (1968), at p. 33.

\textsuperscript{26} See, in general, Barak, \textit{ibid.}, at pp. 33-4.

course. Cases denying a holder in due course status to such financing institutions go back in Canada to *Federal Discount Corp. Ltd. v. St. Pierre*. Their doctrinal basis has however never been clear. Professor Littlefield was of the opinion that the effect of similar consumer financing cases in the United States was to demonstrate that "[t]he myth that the good faith test is a subjective one is just that — a myth. Courts have sought to determine what class of purchasers should enjoy that extraordinary protection and freedom from defenses. . . . In the run-of-the-mill commercial case, a test of actual knowledge has been adequate." At the same time, "a close connection between financing agency and the dealer in a consumer financing transaction will be grounds for finding a duty to police, inquire, or back-check". The general test of good faith ultimately includes, according to Professor Littlefield:

... the observance of the reasonable commercial standards which are appropriate to the business in which the parties are engaged or to the transaction of which the purchase is a part.

Along similar lines, Professor Kripke expressed the opinion that the "close connectedness doctrine" introduced objective elements into the good faith standard. Others attempted, though to my mind unconvincingly, to fit the doctrine into the traditional good faith standard. Thus, according to Falconbridge, the circumstances of the close association between the endorsee and the payee in *Federal Discount* were "such as to arouse suspicion of good faith". *Levenhurst Investments Ltd. v. Oakfield Country Club Ltd.* stands for the proposition that "[t]he basis of the St. Pierre case is that both the dealer and the finance company were engaged in one business". Also in *Bank of Montreal v. Kon*, Kirby J. stated that:

To bring the relationship [between a financer and seller] within the *Federal Discount* doctrine the evidence must establish or warrant the

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30 Ibid., at p. 74.
31 Ibid.
33 Supra, footnote 3 at p. 632.
inference that the [financer] was a party to the wrongful acts of [the seller] or knew, or ought to have known, the wrongful acts ...$^{35}$

Elsewhere I have expressed my disagreement with these views of *Federal Discount*. $^{36}$ My opinion is that the case is neither a deviation from the good faith standard, nor an example of the traditional subjective good faith test. The case rather stands for the proposition that a good faith purchaser must be remote in relation to the original dealings between the maker and the payee. "Indeed, the involvement in the arrangement from its inception is by itself the key to the doctrine." $^{37}$ The doctrine does not deal with the good faith standard; it is rather concerned with who may be a good faith purchaser.

With the enactment of Part V (ss. 188 to 192) of the Bills of Exchange Act, $^{38}$ the close connectedness doctrine has been bypassed in relation to instruments issued under consumer purchases. Part V effectively abolishes the holder in due course doctrine in connection with such instruments. $^{39}$ None the less, retail transactions falling outside the ambit of "consumer purchase" $^{40}$ are not covered by Part V. I believe that with respect to these transactions the Act should be amended by either expanding the scope of Part V or by defining those business relationships between an endorsee and payee which will disqualify the former from becoming a holder in due course.

The last point to be mentioned here is the holding in due course by


$^{37}$ Ibid., at p. 99.


$^{39}$ The holder "of a consumer bill or ... note that is marked as required by section 190 ... is subject to any defence or right of set-off, other than counter-claim, that the purchaser would have had in an action by the seller": s. 191.

$^{40}$ Under s. 188:

"consumer purchase" means a purchase, other than a cash purchase, of goods or services or an agreement to purchase goods or services

(a) by an individual other than for resale or for use in the course of his business, profession or calling, and

(b) from a person who is engaged in the business of selling or providing those goods or services;

This does not include for example, a retail purchase for business purposes; cf., e.g., *Canadian Imperial Bank of Commerce v. Lively* (1974), 46 D.L.R. (3d) 432, 19 N.S.R. (2d) 400 (S.C.T.D.).
position of a depositary bank. The subject is governed by s. 165(3) which provides:

(3) Where a cheque is delivered to a bank for deposit to the credit of a person and the bank credits him with the amount of the cheque, the bank acquires all the rights and powers of a holder in due course of the cheque.

According to Falconbridge, s. 165(3) was added to the Act in 1966 “after an Alberta decision that a cheque endorsed ‘Deposit only to the account of “A”’ and signed “A” was a restrictive endorsement, and that the bank in which it was deposited was not a holder in due course”.

In that case, Imperial Bank of Canada v. Hays and Earl Ltd., the plaintiff depositary bank received from its customer a cheque restrictively endorsed for deposit. The bank credited the customer’s account before the cheque had been cleared, and allowed him to draw on his account. Upon the cheque being dishonoured, the drawer was allowed to assert against the bank a defence available to him against the payee-customer of the plaintiff depositary bank.

Needless to say, the language of s. 165(3) covers more than the case of a cheque restrictively endorsed for deposit. In fact, s. 165(3) is drafted so as to exempt the depositary bank from all holding in due course conditions. The Law Reform Commission of Canada recommended replacing existing s. 165(3) with provisions modeled on Article 4 of the UCC. Such provisions define the modifying conditions for compliance with the holding in due course provisions in the case of a depositary bank. They provide that neither a restrictive endorsement nor the lack of endorsement shall stand between the depositary bank and the status of a holder in due course. Furthermore, “value” in the collection system is given by the depositary bank not by merely crediting the customer’s account, as presently provided for by s. 165(3), but rather by letting the customer actually withdraw against such credit. This is consistent with the general approach

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41 Supra, footnote 3 at p. 860.
44 Law Reform Commission of Canada, The Cheque: Some Modernization, Report 11 (Ottawa, Ministry of Supply and Services, 1979), at pp. 31-3, reviewed by Ian F. G. Baxter in 4 C.B.L.J. 112 (1979-80). The UCC provisions are ss. 4-208 and 4-209. See also UCC 4-205 (depositary bank’s right to supply customer’s endorsements; no notice by non-depositary bank from prior intervening endorsement).
of Article 3 to "executory consideration" in connection with the taking for value requirement.\textsuperscript{45} No special rule is laid down as to compliance with the "good faith" and "without notice" element.\textsuperscript{46}

I believe that such recommendations are steps in the right direction. A depositary bank is likely to let its customer withdraw against provisional credit at least partly on the basis of its expectation that the cheque will be paid, namely on the strength of the drawer's engagement to honour it. By letting its customer withdraw against an uncollected cheque, the depositary bank gives actual value and becomes a good faith purchaser of the cheque. As such it should be allowed to enforce the drawer's obligation free from his defences.

However, two limits should be imposed on the depositary bank's powers as a holder in due course. First, the bank should not be entitled to exercise its powers before exhausting its remedies against its customer. For example, suppose Drawer gives a cheque to Payee who deposits it in his bank account with Depositary Bank; the latter credits Payee's account and lets him withdraw funds against the amount so credited; the cheque is dishonoured. Depositary Bank should not be allowed to proceed against Drawer before it exhausts its remedies against Payee (its customer). Credit given in Payee's account is likely to be provisional in any event; Depositary Bank may revoke it as soon as the cheque is dishonoured. When Drawer has defences against Payee, there is no reason why Depositary Bank should be allowed to proceed against Drawer instead of simply revoking the credit previously given to Payee's account. It is only where revocation of credit results in an overdraft that Depositary Bank should be allowed to proceed against Drawer. Moreover, such overdraft must not be according to an overdraft facility previously agreed upon between Depositary Bank and its customer (Payee), and must occur in circumstances where the only effective remedy of Depositary Bank against Payee is to commence a lawsuit.

Second, the depositary bank should not be allowed to enforce the drawer's obligation without first obtaining a judgment against

\textsuperscript{45} See text subsequent to footnote 21, \textit{supra}.

\textsuperscript{46} But \textit{cf.} UCC 4-205(2) and provisions cited as cross reference in the Comment: an intermediary bank, or payor bank which is not a depositary bank, is neither given notice nor otherwise affected by a restrictive endorsement of any person except the bank's immediate transferor.
him. Such a safeguard is important for a drawer who has a bank account with the depositary bank. Without a judgment, the depositary bank should not be permitted to set off the amount of the cheque by merely debiting the drawer's account.\footnote{For the UCC holding in due course conditions see ss. 3-302 to 3-304, 1-201(19) and (25), and 4-208 to 4-209.}

(ii) Results of holding in due course

A holder in due course holds the instrument "free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves, and may enforce payment against all parties liable on the [instrument]" (s. 74(b)). I have discussed elsewhere the meaning of "defect of title" and "mere personal defences".\footnote{Geva, "Equities as to Liability on Bills and Notes: Rights of a Holder Not in Due Course", \textit{supra}, footnote 8 at pp. 61-72.} At this point I wish only to say that a holder in due course holds the instrument free from all defences to liability of prior parties as well as from prior parties' equities of ownership. The range of defences not available against him is frequently characterized as "personal" defences, defences "in personam" or "relative" defences.\footnote{See, \textit{e.g.}, Falconbridge, \textit{supra}, footnote 3 at p. 667; Cowen on \textit{The Law of Negotiable Instruments in South Africa}, 4th ed., Cowen and Gering eds. (1966), pp. 269, 272.}

There is a class of defences, falling outside "defect of title", "relative", or "personal" defences, which is available against a holder in due course. Such defences are characterized as "real" or "absolute".\footnote{See, \textit{e.g.}, Falconbridge, \textit{ibid.}, at p. 666; Cowen, \textit{ibid.}, at p. 268.} According to Falconbridge, "[a] real defence is so-called because, at least as regards a particular defendant who is entitled to set it up, it is based upon the nullity of the res without regard to the merits or demerits of the plaintiff."\footnote{Falconbridge, \textit{ibid.}, at p. 668.} The availability of such a defence against a holder in due course makes it "absolute".\footnote{Cowen, \textit{supra}, footnote 49 at p. 268.}

Forgery of one's signature is invariably a real defence.\footnote{Subject to an explicit estoppel exception: s. 49(1).} Discharge of the instrument by payment in due course is regarded by Falconbridge as another example of a real defence.\footnote{Falconbridge, \textit{supra}, footnote 3 at p. 668. However, since payment in due course cannot take place before maturity of the instrument (s. 139(2)), one who takes the instrument after such payment may not be a holder in due course. See s. 56(1)(a) requiring the taking of the instrument before maturity.}
following is an analysis of two other types of defence falling within the category.

(a) **Defences relating to the nullity of the obligation**

Absolute incapacity of the defendant to make a binding contract is considered a real defence.\(^{55}\) Also, notwithstanding that as a general rule in English law the contract of an infant or minor is voidable and not void, infancy is a real defence to liability on a bill or note.\(^{56}\)

A more frequently discussed real defence is the defence of "*non est factum*" (NEF), or "it is not his deed". This defence is based on fraud, the effect of which is so strong as to make the contract void and not merely voidable. The fraud must be in relation to the material content of the instrument, its character or its nature; mere fraud in inducement, or concealment of essential terms of the contract is not sufficient. To invoke the defence, the signer must have been led to believe that he was not signing a negotiable instrument at all;\(^{57}\) the fraud must be "in the factum" and not "in the inducement".

The leading case is *Foster v. Mackinnon.*\(^{58}\) In that case, defendant believed he was signing a guarantee but, in fact, he signed as an endorser of an instrument. Byles J. found that defendant "was deceived, not merely as to the legal effect, but as to the *actual contents* of the instrument".\(^{59}\) He could therefore assert his defence against a holder in due course. The case "has been criticized on the facts on the ground that the liability of a guarantor and that of an endorser are so similar that Mackinnon’s signing as endorser under the belief that he was signing as guarantor was not a case of his signing a contract ‘of a nature altogether different’ from the contract he intended to sign."\(^{60}\) Yet apart from the particular facts of the case, its rule of law has not been in doubt for a long period. A good example of the use of the NEF defence is the case of a consumer\(^{61}\) who was fraudulently led

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\(^{55}\) Falconbridge, *supra*, footnote 3 at p. 668.


\(^{58}\) (1869), L.R. 4 C.P. 704.

\(^{59}\) *Ibid.*, at p. 713.

\(^{60}\) Falconbridge, *supra*, footnote 3 at p. 673.

\(^{61}\) Of course, consumer instruments are presently covered by Part V of the Act. For explaining the NEF defence the old cases are still relevant.
to believe that the goods had been given to her for "advertisement", who "did not know she was signing or intended to sign what is claimed to be a note", and who thought her signature was a mere acknowledgement of the delivery of the goods. 62

This traditional framework for NEF suffered a serious setback in the decision of Lord Denning M.R. in Gallie v. Lee. 63 First, Lord Denning was very critical of the distinction between class and contents. His view was that "it is not a sensible distinction":

A mistake as to contents may be just as fundamental as a mistake as to class and character. ... Suppose a man signs a paper without reading it. He is told it is a bill of exchange for £100; whereas it is in truth a bill of exchange for a much larger sum of £10,000. ... The maker there made a fundamental mistake but it was only a mistake as to the contents of the document ... for it was, in any case, a bill of exchange. It is agreed ... that in that case he cannot plead that it was not his document. 64

He found that the distinction between class and contents is often a question of degree: "[T]he distinction is not really a distinction at all. A document takes its class and character from its contents; and a mistake as to the one is often also a mistake as to the other." 65

In addition, Lord Denning concluded that one who signs a document owes a duty of care to the entire world:

Whenever a man of full age and understanding, who can read and write, signs a legal document which is put before him for signature — by which I mean a document which, it is apparent on the face of it, is intended to have legal consequences — then, if he does not take the trouble to read it but signs it as it is, relying on the word of another as to its character or contents or effect, he cannot be heard to say that it is not his document. By his conduct in signing it he has represented, to all those into whose hands it may come, that it is his document .... 66

This means that the defence of NEF can be met by an argument based on the signer's negligence. In connection with bills and notes, the possibility of such a rule had already emerged in Carlisle and Cumberland Banking Co. v. Bragg. 67 However, it appears from Foster v. Mackinnon 68 itself, that the negligence

64 Ibid., at p. 1067.
65 Ibid., at p. 1068.
66 Ibid., at p. 1072.
68 Supra, footnote 58.
referred to there is only the negligence of a signing party who "knows what he is doing", namely one who is signing what is known to him to be a blank negotiable instrument. In this respect, Lord Denning's innovation is twofold. First, he established the principle that negligence is an answer to a NEF defence in connection with all documents, not merely negotiable instruments. Secondly, according to Lord Denning, a signer who does not read carefully the document put before him for signature may find himself liable on his signature even if he did not know what he was doing, provided there was no evidence of incapacity. This means that in the framework established by *Gallie v. Lee* a signer who was not aware that he was signing a negotiable instrument would not be discharged if he was careless in signing the document.

The House of Lords unanimously affirmed the Court of Appeal's decision and, subject to a few modifications, gave its approval to the tenor of Lord Denning's judgment. It held that, for the NEF defence to apply, there must be a radical and fundamental difference between the document signed, and the document intended to be signed. The class/contents distinction was found to be "helpful in some cases, but [capable of producing] wrong results if it were applied as a rigid rule for all cases". The law lords were also agreed that, while no duty of care is owed by a signer to a third party relying on the signed document, in the absence of some form of incapacity on his part, a signer cannot establish a successful NEF defence without proving that he acted carefully in signing the document.

It is noteworthy that *Gallie v. Lee* is consistent with the solution adopted by the drafters of the UCC:

§3-305. Rights of a Holder in Due Course

To the extent that a holder is a holder in due course he takes the instrument free from

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69 Supra, footnote 58 at p. 712. The negligence of the signer of a negotiable instrument is a factor because "[t]hese instruments are not only assignable, but they form part of the currency of the country. A qualification of the general rule is necessary to protect innocent transferees for value", ibid. "The general rule" referred to in the last sentence is apparently that negligence is no answer to a NEF defence.


(2) All defenses of any party to the instrument with whom the holder has not dealt except

(a) infancy, to the extent that it is a defense to a simple contract; and

(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and

(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and

(d) discharge in insolvency proceedings; and

(e) any other discharge of which the holder has notice when he takes the instrument.

Subsection (c) deals with the NEF defence. Under that subsection, the fraud which renders the instrument void as against a holder in due course is not limited to the "character" of the instrument; it could also relate to "its essential terms". Moreover, to succeed, the defendant must prove not only lack of knowledge, but also lack of "reasonable opportunity to obtain knowledge". This suggests that the signer's negligence, expressed in his failure to know notwithstanding the existence of "reasonable opportunity to obtain knowledge", is an answer to a NEF defence.

It is far from certain whether, as a matter of policy, a defence based on the nullity of the signer's obligation should be available at all against a holder in due course.

It is only the accident of historical development which renders a contract void for mistake and voidable for fraud. Why should this distinction be carried into the law of bills of exchange? Are the material grounds for distinguishing between a void and a voidable obligation in the law of contract also material in the law of bills? Are they consistent with the nature of a bill as a negotiable instrument?74

There is no unequivocal answer to these questions. Likewise, it is far from certain whether Gallie v. Lee is necessarily a step forward. It appears to balance carefully the interests of the signer and those of the third party, and thus appears to be a substantial improvement over the mechanical rules which preceded it. Yet by repudiating the distinction between class and contents and expanding the role of negligence as an answer to a NEF defence,

74 Barak, supra, footnote 25 at pp. 38-9.
the decision introduces uncertainty. Undoubtedly, in the law of bills and notes this is not a desirable result.

Recent NEF judicial developments in Canada are not encouraging. First, there is confusion as to whether Gallie v. Lee is to be followed, or whether it would be better for the orthodox class/contents distinction to continue. Secondly, some courts have erroneously considered the NEF defence in situations involving no third-party interests. For example, in Canadian Imperial Bank of Commerce v. Dura Wood Preservers Ltd., a guarantor was innocently misled by the creditor as to the amount of the guaranteed debt. When he was sued by the misrepresenting creditor on the guarantee, the guarantor pleaded NEF. It was found that he had signed the document without reading it. His defence failed and he was held liable for the full amount of the guaranteed debt.

All this does not give much hope for a successful judicial resolution of NEF issues. A legislative intervention seems entirely warranted.

(b) Absence of delivery of incomplete instruments

"Delivery", namely the "transfer of possession, actual or constructive, from one person to another" (s. 2), is essential to

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79 The correct view is that the signer's negligence "should surely not be relevant as against the very party who was responsible for his deception": S.M. Waddams, The Law of Contracts (Toronto, Canada Law Book Ltd., 1977), p. 205 at note 64. The case was thus wrongly decided.

80 NEF may be raised in connection with all types of documents. Therefore, its regulation appears to fall within provincial legislative jurisdiction (British North America Act, 1867 (U.K.), c. 3, s. 92(13)). None the less, in the interest of constitutionally securing the applicability of any reforming statute to bills and notes, NEF legislation purporting to apply to negotiable instruments should be federal (British North America Act, 1867, s. 91(18)).
render effective a negotiable instrument or the contract of any party to it (ss. 2, 39, 178). In order that any party to the instrument may be liable, he must not only have signed it but also have delivered it. Until delivery to a holder, the contract on the instrument is incomplete and revocable.

However, the defence of absence of delivery is not available against a holder in due course. Under s. 40(2):

(2) Where the bill is in the hands of a holder in due course, a valid delivery of the bill by all parties prior to him, so as to make them liable to him, is conclusively presumed.

This suggests that absence of delivery is not a real defence. However, s. 40(2) applies only with respect to negotiable instruments which were complete in form when they left the signer's possession. As to incomplete instruments, ss. 31 and 32 should also be considered. These provisions read as follows:

31. Where a simple signature on a blank paper is delivered by the signer in order that it may be converted into a bill, it operates as a prima facie authority to fill it up as a complete bill for any amount, using the signature for that of the drawer or acceptor, or an endorser; and, in like manner, when a bill is wanting in any material particular, the person in possession of it has a prima facie authority to fill up the omission in any way he thinks fit.

32.(1) In order that any instrument referred to in section 31 when completed may be enforceable against any person who became a party thereto prior to its completion, it must be filled up within a reasonable time, and strictly in accordance with the authority given; but where any such instrument, after completion, is negotiated to a holder in due course, it is valid and effectual for all purposes in his hands, and he may enforce it as if it had been filled up within a reasonable time and strictly in accordance with the authority given.

(2) Reasonable time within the meaning of this section is a question of fact.

Under the proviso of s. 32(1), a holder in due course holds the instrument free from prior parties' defences based on unauthorized completion of the instrument. It has however consistently been held that there is nothing in this proviso to enable a holder in due course to defeat the defence of want of delivery of an incomplete instrument. Accordingly, "[t]he defence of want of delivery [of an incomplete instrument] is a real

But see McKenty v. Vanhorenback (1911), 21 Man. R. 360 (C.A.); absence of initial delivery (or issue) may be raised against a holder in due course. The case is criticized by Falconbridge, supra, footnote 3 at p. 538.

defence available against the whole world, not merely a defect of
title which cannot be set up against a holder in due course”.

Furthermore, “delivery” in connection with ss. 31 and 32 has
been construed quite narrowly. As explained below, these provi-
sions apply only to cases in which an incomplete instrument has
been delivered in order that it may be completed so as to be
issued or negotiated. In this situation it is proper to consider the
transfer of the instrument by the signer as “delivery”. The provi-
sions do not apply to cases in which an incomplete instrument has
been delivered by the signer for a purpose other than issue or
negotiation. In such a case there is no “delivery” of an instrument
by the signer. The proviso of s. 32(1) protects a holder in due
course from a defence based on the unauthorized completion of
the instrument, but not from a defence based either on the
absence of delivery or on the fact that delivery was made for a
purpose other than issue or negotiation.

The leading case is Smith v. Prosser. In this case, the
defendant placed two blank notes signed by him as maker in the
hands of his attorney. The instructions given to the attorney were
to retain the documents until the defendant gave him new instruc-
tions. The new instructions were to relate to the issuance of the
documents as promissory notes for the purpose of raising money
upon them, as well as to the amounts by which they should be
filled up. No new instructions were ever given. The attorney
fraudulently filled up the documents and used them as promissory
notes for his own purposes. In an action by the payee it was
concluded that the defendant had entrusted the blank signed
forms to the attorney only in the attorney’s character as custo-
dian, without giving him authority to issue them as promissory
notes. It was therefore held that the defendant was not liable.

Plaintiff in Smith v. Prosser was the payee of the notes; “there
was no negotiation to him after completion, and the case ... was
not within the proviso to s. 32”. None the less, “[a]ll the
members of the Court of Appeal who heard the case put their
decision ... on the broad ground that the documents had never
been delivered by the signer with the intention that they might be
converted into complete notes”. Vaughan Williams L.J.
explicitly stated that "in the absence of a delivery of notes to an agent with the intention that they shall be negotiated, or at any rate that the agent shall have power to negotiate them, the signer is not responsible even to a bona fide holder for value." Fletcher Moulton L.J. was even more specific. Relying particularly on the opening clause of s. 31, his view was that ss. 31 and 32 are "based upon the doctrine of common law estoppel" and that therefore "the intention that the document should be converted into a bill of exchange [is] essential in order to render the maker liable" under these provisions.

This construction of ss. 31 and 32 was followed in Canadian cases where Smith v. Prosser was extended to situations involving a signed blank instrument delivered to an agent with authority to fill it up and negotiate it on the occurrence of a future event. In each case the event had never happened and the agent had fraudulently filled up the instrument and used it for his own purposes. In each case a holder in due course failed to recover on the instrument. The effect of these cases is that the proviso of s. 32(1) protects a holder in due course in cases where an agent has exceeded his limited authority as to completion, such as where he writes in a higher sum than was authorized. The proviso does not protect such a holder where the agent's authority to complete and issue was subject to an unfulfilled condition subsequent.

The law does not appear to me to be in a satisfactory condition. As a general rule, one who entrusts a signed blank form of a negotiable instrument to another should bear the loss resulting from his bailee's fraud. In particular, where a blank signed instrument is given to an agent with the authority to fill it up and issue it either following further instructions, or on the occurrence of a certain event, one who takes the instrument in good faith should be able to overcome a defence based on the issue or negotiation without authority. It is hard to see why such a third party should not be protected where the agent fills up the instrument and issues it without waiting either for the signer's instructions or for the occurrence of the event. The third party's

87 Supra, footnote 84 at p. 745, emphasis added.
88 Supra, footnote 84 at p. 753.
90 These cases are criticized by Falconbridge, supra, footnote 3 at p. 539.
position towards the agent does not appear to be significantly different from that of a \textit{bona fide} third party towards an agent with a limited authority, namely an agent who was authorized to fill the incomplete instrument with a figure up to a certain amount and then to issue or negotiate it but who exceeded his authority and put in a higher sum. In both cases, and not only in the latter, the loss should be allocated to the signer. \textit{Smith v. Prosser} is premised on the obsolete notion that no duty of care to the public is owed by a document signer,\textsuperscript{91} a position that does not reflect sound commercial policy.

The drafters of the American Code got rid of this anomaly. Under s. 3-115, the unauthorized completion of "a paper whose contents at the time of signing show that it is intended to become an instrument", is subject to the rules as to material alteration, "even though the paper was not delivered by the maker or drawer". Under the rules as to material alteration, when an incomplete instrument has been completed, "[a] subsequent holder in due course" may enforce it as completed (UCC 3-407(3)). A party may be precluded from asserting the defence of material alteration even as against one not holder in due course (UCC 3-407(2)(a)).

The treatment of real defences in the Act is far from satisfactory. There is neither a comprehensive delineation of these defences nor is there an adequate statement as to the holder in due course's position in relation to them. In addition, neither the Act nor the case law reflects consideration or formulation of an adequate doctrinal or policy framework within which the courts can function to reach satisfactory solutions.

(iii) The payee as a holder in due course

The special position of the holder in due course has always been explained by the currency quality of the negotiable instrument.\textsuperscript{92} Thus, to be a holder in due course one must be a \textit{bona fide} purchaser, a remote party to the actual dealings which originally gave rise to the negotiable instrument.\textsuperscript{93}

It follows that typically, a payee will not qualify as a holder in

\textsuperscript{91}These premises as to the lack of the duty of care emerge particularly from the judgment of Vaughan Williams L.J., \textit{supra}, footnote 84 at p. 746. For the obsolescence of these notions see the preceding section dealing with NEF and Part III, text and footnotes 214-19, \textit{infra}.

\textsuperscript{92}This explanation goes back to \textit{Miller v. Race} (1758), 1 Burr. 452, 97 E.R. 398.

\textsuperscript{93}For the distinction between "remote" and "immediate" parties, \textit{cf.} s. 40(1).
due course. In general a payee takes the instrument as a direct promisee, rather than as a purchaser. There are, however, situations where a payee acquires an instrument as a purchaser. For example, it is not uncommon for a buyer from a retailer, who borrows money from a bank to pay for the purchase, to pay for the goods with a bank draft (i.e., a bill of exchange whose drawer is a bank). It was well established in pre-Act English case law that the payee in such a situation is a purchaser of the instrument. The one who procured the issuance of the draft payable to the order of another, the buyer in the previous example, was called the “remitter”. He was treated in those cases as the first owner of the instrument, who was in a position “to confer title... upon the payee”. Can such a payee qualify as a holder in due course?

The English pre-Act cases dealing with a situation where the remitter defaulted on his obligation to the drawer-bank, gave an affirmative answer. They specifically held that where the payee of a bank draft acquires it for value, in good faith, and without notice of any defence available to the drawer bank against the remitter, such a payee enjoys a holder in due course status. He may enforce the drawer's obligation irrespective of the latter's defences against the remitter.

The attribution of holder in due course status to the payee on a bank draft is consistent with the view that prior to the delivery of the instrument to the payee, the remitter was its owner. Having a derivative title to the instrument, the payee is a remote party to the actual dealings which originally gave rise to the instrument. True, such a payee is the named promisee on the bill, and since only he can become its first holder, the sale of the instrument to him is a far cry from free circulation of commercial paper. None the less, the payee acquires his rights under the bank draft by sale from the remitter, rather than by virtue of a direct relationship with the drawer. Indeed, as has been demonstrated by courts in the United States, the purchasing remitter's ownership of the bill payable to the order of a third person is not only the basis for the

94 Aigler, “Payees as Holders in Due Course”, 36 Yale L.J. 608 (1927), at p. 631.
payee’s holder in due course status but is also the foundation for the remitter’s own rights under the instrument:

Suppose, upon a rightful tender of the instrument by the remitter or by the agent of the issuer to the payee, the payee refuses to accept it, what are the rights of the party in possession against the signers thereof? Or, again, suppose that after such refusal by the payee to accept the tendered instrument, the party in possession transfers it for value to some person other than the payee, what are the rights of such transferee against the signers of the instrument? Where a purchasing remitter is in possession after the payee has refused to accept it, or, where the purchasing remitter has decided not to tender the instrument to the payee, the remitter is the owner thereof, although not the holder, but, as owner, the remitter has a right to recover from the maker or drawer by an action on the instrument ... 97

The remitter’s ownership thus provides a basis for a comprehensive framework dealing with rights in relation to bank drafts; the payee’s holder in due course position fits easily into this framework. None the less, the orthodox view is that the authority of the pre-Act cases supporting the holder in due course status of the payee on a bank draft has not survived the enactment of the United Kingdom Bills of Exchange Act and that a payee may not be a holder in due course. 98 The only possible exception to this is the position of a payee on a bill of exchange as towards the acceptor. Being a remote party in relation to him, such a payee “is not liable to be defeated either by defects of title or by any personal defence which the acceptor may set up against the drawer”. 99 At the same time, as against the drawer or the maker a payee may not be a holder in due course.

The orthodox view is based on three leading cases, as well as on the language of the Act. I will first discuss these authorities, then consider the challenge presented by two Canadian cases, and finally examine the legislative solution under the American UCC. I will argue that the UCC solution goes beyond the restoration of the law to its pre-U.K. Act condition and that it rather constitutes a departure from existing principles of law. This departure does not appear to me to be justifiable, so reformers should examine the UCC model with great caution.

The first decision cited in support of the proposition that a payee may not be a holder in due course is Lewis v. Clay. 100 In

99 Ibid., at p. 199.
100 (1897), 67 L.J.Q.B. 224, 77 L.T. 653.
that case, one of two joint makers of a promissory note attempted to meet the payee's action with the defence that his signature had been obtained by the co-maker's fraud. He was successful in pleading NEF. In his judgment, Lord Russell C.J. also considered the possible status of the payee as a holder in due course:

It will be apparent from a consideration of the facts of the case that the plaintiff was not a "holder in due course" at all, but that he was, in fact, simply the named payee ... Further ... "a holder in due course" is a person to whom, after its completion by and as between the immediate parties, the bill or note has been negotiated. In the present case the plaintiff is named as payee on the face of the promissory note, and therefore, is one of the immediate parties. The promissory notes have, in fact, never been negotiated within the meaning of the Act.

It is hard to tell from this statement how much the decision turned on "the facts of the case" and how much it turned on the proposition that "the plaintiff is named as payee ... and therefore, is one of the immediate parties" who can never be a holder in due course. In any event, it is important to note the assumption of Lord Russell that only one who takes an instrument by negotiation can qualify as a holder in due course.

Under the Act, a holder in due course must take the instrument by negotiation (s. 56(1)(b)). "A bill payable to order is negotiated by the endorsement of the holder completed by delivery" (s. 60(3)). Since the payee under an instrument is always its first holder, he cannot take it from a previous holder as required by s. 60(3). Nor does he take the instrument from the first owner by "endorsement". Hence, the argument goes, since a payee cannot acquire the instrument by "negotiation" as defined in s. 60(3), he can never qualify as a holder in due course.

It is, however, plausible to suppose that in drafting the statute the drafters of the English Act had in mind the typical fact situation where the payee is an immediate party to the transaction, and that they did not consider the situation of a payee who is a remote party. The statutory language could therefore be simply

101 For NEF and its availability against a holder in due course, see section (ii), supra.
103 Ibid., emphasis added.
104 "Holder" under s. 1 is "the payee or endorsee of a bill or note who is in possession of it".
105 Cf. footnote 95 and text, supra; the payee taking the instrument from the remitter takes it from the first owner but not by endorsement.
the result of an oversight rather than of a careful scheme under which a payee may not be a holder in due course. Moreover, as a matter of statutory construction, the definition of "negotiation" in connection with instruments payable to order should not necessarily be read so as to be confined to the wording of s. 60(3). The general concept of "negotiation" is broadly defined in s. 60(1) as a transfer of a bill "in such a manner as to constitute the transferee a holder of the bill". Acquisition by negotiation under s. 60(1) denotes the existence of a derivative title in the hands of the holder, the remoteness of the holder-aquirer from the underlying transaction, or the manner of becoming "the mercantile owner of the instrument" by transfer. The next two subsections of s. 60 can then be considered to deal with negotiation by a holder, or to constitute examples of the most typical cases of "negotiation". Section 60(2) deals with the typical negotiation of a bearer instrument, and s. 60(3) deals with that of one payable to order. These subsections should not be taken, however, to qualify the generality of s. 60(1) or to exhaust all cases of "negotiation". Accordingly, there is room for more instances of "negotiation" not provided for by subsecs. (2) and (3) of s. 60, which are none the less within the broad framework of s. 60(1).

Lewis v. Clay is therefore far from being unequivocal in establishing a general proposition as to the inability of a payee to become a holder in due course. By insisting on "negotiation" the case could be regarded as merely reaffirming the position that a holder in due course must be a purchaser of the instrument. On its facts the case did not involve such a purchaser.

The second case cited in support of the view that a payee may not become a holder in due course is Herdman v. Wheeler. In this case, a maker of a promissory note placed a signed blank note in the hands of a middleman instructing him to arrange for a loan (to the maker) known to come from a certain lender. The maker instructed the middleman to fill his (the middleman's) own name as payee and to insert a specific sum of money. The middleman defied the instructions, put the actual lender's name as the payee, put a higher sum, delivered the note so filled to the lender, and

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106 For this definition of holder, see Chalmers, supra, footnote 15 at pp. 7-8.
108 Supra, footnote 102.
then converted the proceeds of the loan so received to his own use. The lender, the payee on the note, sued the maker and claimed a holder in due course status.

Payee failed. However, "[t]his case . . . which has been so frequently cited for the position that payees may not be holders in due course instead of so deciding, expressly declares the contrary to be the fact". 110 The court stated that it was "not prepared to hold that a payee of a note can never be a holder in due course". 111 It also held that whether "the payee of a note may be a holder in due course . . . depends on the actual state of facts as between him and the maker". On the particular facts of the case, the court found "much to support [the] argument" that payee dealt directly with the maker and thus there was privity of contract between them. 112 Since payee and maker were immediate parties to the underlying loan agreement, payee could not claim that the note had been negotiated to him so as to overcome the defence of unauthorized completion of the instrument under s. 32(1). 113 Indeed, as the payee was not a purchaser of the instrument but rather a direct party to a contract with the maker, he could not become a holder in due course.

Unfortunately, the decision went slightly further than holding that on the facts the payee was not a holder in due course. Channell J. specifically stated that "negotiated" in the proviso of s. 32(1) "meant transferred by one holder to another". 114 This appears to mean that apart from the particular facts of the case, the court was of the opinion that as a matter of construction of the Act, "negotiation" cannot take place where the transferee is the payee, since his transferor is not a holder. Channell J. explicitly limited his statement regarding the meaning of "negotiated" to its use in s. 32(1), dealing with the specific question of unauthorized completion. He did not purport to apply this interpretation to the term as used in s. 56(1)(b) dealing with acquiring a holder in due course status. 115 Yet, the problem of a payee as a holder in due course can arise also in the context of s. 32(1). Suppose A takes from B a blank cheque for value. The cheque is signed by B who

110 Aigler, supra, footnote 94 at p. 616.
111 Supra, footnote 109 at p. 372.
112 Supra, footnote 109 at p. 374.
113 Section 32(1) is reproduced in section (ii), text which follows footnote 82, supra.
114 Supra, footnote 109 at p. 376.
115 A point emphasized by Byles, supra, footnote 98 at p. 198.
instructs A to fill it with a certain sum of money and with his (A’s) name as payee. Exceeding his authority, A inserts a higher sum, fills C’s name in as payee, and gives the completed instrument to bona fide C, who takes it for value. C is a purchaser of B’s instrument who could qualify under the pre-Act cases as a holder in due course. It is incongruous to argue that he qualifies as a holder in due course under s. 56(1)(b) but not under s. 32(1). The construction given by the court to “negotiated” in s. 32(1) in Herdman v. Wheeler is thus quite unfortunate. On its facts, the case did not involve a payee who could be a holder in due course. There was no need to go beyond that.

The third case and probably the highest authority frequently cited in support of the proposition that a payee may not become a holder in due course is the House of Lords’ decision in R. E. Jones Ltd. v. Waring and Gillow Ltd. In this case a debtor of the payee fraudulently induced the drawer to draw a cheque payable to the order of the payee for a consideration alleged by the debtor to be given to the drawer by the payee. The drawer placed the cheque in the hands of the debtor who in fact used it to pay his own debt to the payee. The cheque was paid. When the drawer discovered the fraud he sued the payee. Payee claimed a holder in due course status.

Payee failed. According to Professor Aigler, on its facts the case was correctly decided since the drawer had intended to deal with the payee. “However this may be, the generality of the language as to the situation of a payee under the Bills of Exchange Act leaves it very difficult for any other and therefore inferior English court to reach what is believed to be the sound conclusion.” Falconbridge believes that “the case appears to be open to criticism, as being based on technical and not wholly convincing reasoning, and as reaching a conclusion which is not entirely satisfactory from the practical point of view, because there are situations in which a payee should logically be as fully protected as a subsequent holder.” He none the less acknowl-

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116 Cf. Smith v. Prosser, [1907] 2 K.B. 735 (C.A.), discussed at length in section (ii), supra. Vaughan Williams L.J. regarded plaintiff/payee as a purchaser of the note (ibid., at p. 744) but “agree[d] with the contention ... that [s. 32(1)] does not really apply in the present case” (ibid., at p. 742).


118 Aigler, supra, footnote 94 at p. 619.

119 Falconbridge, supra, footnote 3 at pp. 625-6.
edges that "Jones v. Waring has been followed in Canada as being settled law".  

Indeed, the generality of some language in Jones v. Waring is quite troublesome. Viscount Cave, for example, explicitly expressed the view that the expression "holder in due course" does not include the original payee.  

Lord Shaw was more cautious: "It was never a negotiated cheque . . . The cheque never went into the circle by transfer or indorsement, and it is in these circumstances . . . inappropriate to use language as to 'a holder in due course' as applicable to the position of a direct payee of a cheque".  

Acquisition by negotiation appeared to be necessary for acquiring a holder in due course status. But whether "negotiation" requires the holder's endorsement as an essential element thereto does not emerge clearly from the decision.  

The orthodox view is that the decision settled it "once and for all" that a payee cannot become a holder in due course.  

Proponents of this view often state that a payee who takes the instrument on the conditions specified in s. 56(1) "save that he took the instrument as payee instead of having it 'negotiated' to him", "has the same rights [as a holder in due course] vis-à-vis a remote party such as the acceptor". It is, however, not entirely clear on what basis this proposition rests. Ordinarily, a payee on a bill of exchange, being direct promisee of the drawer's promise, is not a purchaser of the instrument. As such he cannot become a holder in due course.  

It is arguable, notwithstanding Aigler, that under the pre-Act cases, payee in Jones v. Waring could qualify as a holder in
due course. It is true that the drawer intended to deal with the payee; however, the payee did not intend to deal with the drawer but simply purchased the drawer’s cheque from his debtor.\(^{127}\) It is plausible to argue that whether a “good faith purchase” exists should be determined from the payee’s viewpoint. In any event, no matter how the particular case should have been decided, it is important to take note of its unusual fact situation. In light of these facts, to draw general firm conclusions of law from the case is unwarranted.

There has been some case law in Canada which suggests that a payee may be a holder in due course. For example, in *Johnson v. Johnson*\(^{128}\) the drawer owed money to a third party, and the third party owed money to the payee, so the third party requested the drawer to pay him by a cheque made payable to the payee. The third party delivered the cheque to the payee. It was held by the trial court that the payee was a holder in due course who could enforce payment against the drawer, notwithstanding the latter’s defences against the third party.\(^{129}\) Payee in that case was a remote party, effectively the purchaser of the instrument from the third party. The decision is, therefore, perfectly consistent with the view that a payee/purchaser of the instrument may be a holder in due course.

Ultimately, *Johnson v. Johnson* did not turn out to be a challenge to the authority of *Jones v. Waring*. In fact, it was finally acknowledged by the Appellate Division of the Alberta Supreme Court that “*Jones v. Waring* . . . which was not cited by counsel and was unfortunately overlooked, where it was held that the original payee of a cheque is not a ‘holder in due course’ . . . must now be accepted as the last word on the subject, at all events where the facts are similar to those in question in that case”.\(^{130}\)

The Appellate Division affirmed the earlier decision but on the basis that the cheque in *Johnson v. Johnson* was payable to payee or bearer, and as such constituted a bearer instrument trans-

\(^{127}\) See facts, footnote 117 and subsequent text, *supra*.


\(^{129}\) The third party was instructed not to give the cheque to the payee “until further instructions from [drawer] that funds were available”. He gave him the cheque notwithstanding these instructions without telling him “of the condition attached to the delivery of the cheque”: [1928] 2 D.L.R. 531 at p. 532, [1928] 1 W.W.R. 774 at p. 775 (Alta. S.C. App. Div.).

ferable by delivery alone. This view as to the classification of an instrument payable to payee or bearer as a bearer instrument is consistent with the position of the American UCC as well as with Chalmers' opinion, although the only case cited by him in his commentary on "bearer" is not unequivocal.

A more recent case finding a payee to be a holder in due course is Central Factors Corporation Ltd. v. Bragg. Here cheques were signed by an agent defrauding his principal (the named drawer). The payee took the cheques in good faith in discharge of a debt owed to her by the agent. The court found that the agent "was authorized to sign cheques on behalf of [his principal]" and that the payee "took the cheques as a holder without notice of any restriction on [the agent's] authority". The court thus concluded that payee "took the cheques in the role of a holder in due course".

Arguably the case was wrongly decided. Payee was a bona fide party, but it is far from certain that she was a bona fide purchaser. In order to determine that, we need to know more about the circumstances under which payee took the corporate cheques in satisfaction of the agent's debt. The decision fails altogether to provide this information, as well as to discuss existing obstacles to the view that a payee may be a holder in due course.

At this juncture it seems inconceivable that the question of whether a payee may be a holder in due course can be conclusively settled without legislation. It is worthwhile to examine the solution adopted by the UCC, where s. 3-302(2) flatly states that "[a] payee may be a holder in due course". The Official Comment (point 2) accompanying the provision deserves careful reading:

2. Subsection (2) is intended to settle the long continued conflict over the status of the payee as a holder in due course. This conflict has turned very

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131 Section 60(2).
132 UCC 3-111:
   (b) a specified person or bearer...
133 Chalmers, supra, footnote 15 at p. 28.
134 The case of House Property Co. of London, Lim., and Baylis & Durlacher v. London County and Westminster Bank (1915), 84 L.J. K.B. 1846, was concerned with a cheque payable to C "and others or Bearer" and marked "account payee". The court held that the bank was negligent in paying the cheque to the bearer's account rather than to the named payee's without making any inquiry.
136 Ibid., at p. 587 D.L.R., p. 3 W.W.R.
largely upon the word "negotiated" in the original Section 52(4),\textsuperscript{137} which is now eliminated. The position here taken is that the payee may become a holder in due course to the same extent and under the same circumstances as any other holder. This is true whether he takes the instrument by purchase from a third person or directly from the obligor. All that is necessary is that the payee meet the requirements of this section. In the following cases, among others, the payee is a holder in due course:

a. A remitter, purchasing goods from P, obtains a bank draft payable to P and forwards it to P, who takes it for value, in good faith and without notice as required by this section.

b. The remitter buys the bank draft payable to P, but it is forwarded by the bank directly to P, who takes it in good faith and without notice in payment of the remitter's obligation to him.

c. A and B sign a note as co-makers. A induces B to sign by fraud, and without authority from B delivers the note to P, who takes it for value, in good faith and without notice.

d. A defrauds the maker into signing an instrument payable to P. P pays A for it in good faith and without notice, and the maker delivers the instrument directly to P.

e. D draws a check payable to P and gives it to his agent to be delivered to P in payment of D's debt. The agent delivers it to P, who takes it in good faith and without notice in payment of the agent's debt to P. But as to this case see Section 3-304(2), which may apply.\textsuperscript{138}

f. D draws a check payable to P but blank as to the amount, and gives it to his agent to be delivered to P. The agent fills in the check with an excessive amount, and P takes it for value, in good faith and without notice.

g. D draws a check blank as to the name of the payee, and gives it to his agent to be filled in with the name of A and delivered to A. The agent fills in the name of P, and P takes the check in good faith, for value and without notice.

It is obvious that only in the first two examples can the payee safely be regarded as a purchaser of the instrument. Example (c) is *Lewis v. Clay*.\textsuperscript{139} Examples (d) and (e) are in fact variations of *Jones v. Waring*.\textsuperscript{140} Likewise, examples (f) and (g) are variations on *Herdman v. Wheeler*,\textsuperscript{141} unless of course P and D in example

\textsuperscript{137} "[O]riginal Section 52(4)" of the Uniform Negotiable Instruments Law (the predecessor of Article 3 of the Code) corresponded to s. 56(1)(b) of the Canadian Act. The effect of both is that to become a holder in due course one must take the instrument by negotiation.

\textsuperscript{138} UCC 3-304(2) provides as follows:

(2) The purchaser has notice of a claim against the instrument when he has knowledge that a fiduciary has negotiated the instrument in payment of or as security for his own debt or in any transaction for his own benefit or otherwise in breach of duty.

\textsuperscript{139} (1897), 67 L.J.Q.B. 224, 77 L.T. 653.

\textsuperscript{140} [1926] A.C. 670.

\textsuperscript{141} [1902] 1 K.B. 361.
(g) had no dealings between themselves so that P could be truly regarded as a purchaser. All three cases held that the payee was not a holder in due course. Like these examples, they were concerned with a payee who was a bona fide party but not a bona fide purchaser. This does not mean, however, that the examples are wrong. Rather, they reflect a shift in or transformation of the holder in due course concept as actually acknowledged by the Official Comment cited above:

The position here [in 3-302(2)] taken is that the payee may become a holder in due course to the same extent and under the same circumstances as any other holder. This is true whether he takes the instrument by purchase from a third person or directly from the obligor. All that is necessary is that the payee meet the requirements of this section.

Does this mean that any bona fide payee taking the instrument for value, thereby meeting "the requirements of this section", may be a holder in due course? Suppose a payee on a promissory note is a seller of goods. His action on the note against the maker, the buyer of the goods, is defended by an alleged breach of condition or warranty relating to the sold goods. Where the breach was made unknowingly, may the payee-seller meet the defence by claiming a holder in due course status on the basis of his lack of knowledge of his own breach?

One court thought that under UCC 3-302(2) the answer is yes: "No one has suggested that being a party to the underlying transaction bars the holder from being one in due course". One answer to such a far-fetched view is that under UCC 3-305(2) the freedom of a holder in due course extends only to "defenses of any party to the instrument with whom the holder has not dealt". Stated otherwise, even if the seller in the previous example were a holder in due course, he would take the instrument subject to the buyer's defences, since he has dealt with him. The better view seems to be that such a seller is not a holder in due course at all. While UCC 3-302(2) and its accompanying examples appear to omit the purchase requirement, the payee in all the examples

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142 To become a holder in due course, a holder must take the instrument "for value ... and in good faith; and ... without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person": UCC 3-302(1). See in general section (i), supra.


144 For this argument, see Note, "The Concept of Holder in Due Course in Article III of the Uniform Commercial Code", 68 Col. L. Rev. 1573 (1968), at p. 1580.
((a) to (g)) is still a remote party to the actual dealing giving rise to the drawer's or maker's defences. It is therefore plausible to construe UCC 3-302(2) as embodying a remoteness element.

In the final analysis, I would not support the extension of the holder in due course concept to situations which go beyond those in which the holder is a purchaser of the instrument, as was apparently done by the drafters in UCC 3-302(2). Such an extension is inconsistent with the doctrinal and historical basis of the holder in due course concept, and is bound to produce confusion and further unwarranted extension, as was demonstrated above. This however does not mean that the payee in examples (c) to (g) of the Official Comment, as well as in Jones v. Waring,\textsuperscript{145} Lewis v. Clay,\textsuperscript{146} or Herdman v. Wheeler,\textsuperscript{147} should necessarily be defeated. All these are situations in which, under general principles of law, the drawer or maker could have been estopped from raising his defences as against a bona fide payee.\textsuperscript{148}

In all of them the one to be charged with liability was negligent, or at least dealt directly with the swindler. It is the relative negligence or fault, as between payee and the party to be charged with liability, which should determine the ultimate liability. The holder in due course doctrine is entirely irrelevant in deciding this question.

Likewise, an acceptor of a bill should be held absolutely liable to a bona fide payee who changed his position on the basis of the acceptance. In this framework it is unnecessary to invoke the holder in due course doctrine as the freedom of the payee from the acceptor's defences against the drawer has nothing to do with the free circulation of commercial paper. The acceptor's liability is rather based on the payee's actual change of position.

In sum, I would support a legislative solution providing that a payee may be a holder in due course, though such a solution should be drafted more narrowly than was UCC 3-302(2). It should be confined in its application to a payee who is a purchaser of the instrument, so as not to create the opportunity for an uncontrollable extension of the concept as was inadvertently done by the UCC drafters.

\textsuperscript{145} Supra, footnote 140.  
\textsuperscript{146} Supra, footnote 139.  
\textsuperscript{147} Supra, footnote 141.  
\textsuperscript{148} The doctrine of estoppel was invoked in favour of a payee in Lloyd's Bank, Ltd. v. Cooke, [1907] 1 K.B. 794 (C.A.).
II. The Drawee Bank's Right to Recover on Cheques Paid by Mistake of Fact

(i) Introduction

A cheque constitutes an unconditional order in writing addressed by a customer to his bank, signed by the customer, requiring the bank to pay on demand a certain sum in money to the order of a specified person or to bearer.149 Where there are sufficient funds in the customer's account to meet the cheque, or the bank has agreed to provide the customer with overdraft facilities, the bank is under a duty to comply with the customer's order embodied in the cheque and to pay it on presentment.150 This duty is owed by the drawee bank to the customer alone and not to the holder of the cheque.151 Having paid the cheque in discharge of this duty, the drawee bank may lawfully debit the drawer-customer's account with the amount of the cheque. Such payment is also effective to discharge the obligation of the customer to the payee on the cheque, "because the bank has paid the cheque with the authority of the customer".152

An effective order from the customer is thus the basis of both the bank's duty to honour the cheque and its right to charge the customer's account. Where a bank erroneously honours a cheque which does not contain such an effective order, it is not entitled to charge the customer's account. Is the bank entitled to recover the sum so paid from the recipient of the money (hereafter "the recipient")?153

The payor bank's error as to the existence of an effective order may take various forms. First, the cheque presented for payment could bear a forged drawer's signature. Believing that the instrument contains an order by its customer, the payor bank may honour it. Second, a cheque payable to order may bear a forged endorser's signature. While such an instrument contains an order

149 See ss. 17(1) and 165(1).
151 This follows from ss. 127 and 131.
152 Simms, supra, footnote 150 at p. 236.
153 In restitution law, such a recipient is frequently called "payee". Under the Act, the term "payee" designates the first holder of an instrument payable to order, cf. s. 21(4). To avoid confusion, I therefore prefer to designate the recipient of the money "recipient" rather than "payee".
made by the customer of the bank, the order requires the bank to pay either to the payee or to someone deriving his title to the instrument from the payee. A forged endorsement breaks the chain of title to the cheque.\textsuperscript{154} Payment to one who derives his title from the forger does not conform to the drawer’s order. Third, the bank could mistakenly ignore notice either of its customer’s death or of countermand.\textsuperscript{155} Finally, a bank could err in paying a cheque notwithstanding the absence of sufficient funds in the customer’s account or of an applicable agreement as to overdraft facilities.

Among all of these possibilities, the bank’s remedy is provided for by the Act only in connection with the second situation. Under s. 50(1), where a cheque bearing a forged endorsement is paid “in good faith and in the ordinary course of business”, the payor bank “has the right to recover the amount so paid from the party to whom it was so paid or from any endorser who has endorsed the bill subsequently to the forged ... endorsement”.\textsuperscript{156}

Recovery rights of the drawee bank in other circumstances are governed by general principles of law applicable to recovery of money paid under a mistake of fact. The “formidable line of authority” dealing with this general issue has been recently summarized by Goff J. in \textit{Barclays Bank v. W.J. Simms Son & Cooke (Southern) Ltd.} as follows:

From this formidable line of authority certain simple principles can, in my judgment, be deduced: (1) If a person pays money to another under a mistake of fact which causes him to make the payment, he is prima facie entitled to recover it as money paid under a mistake of fact. (2) His claim may however fail if (a) the payer intends that the [recipient] shall have the money at all events, whether the fact be true or false, or is deemed in law so to intend; or (b) the payment is made for good consideration, in particular if the money is paid to discharge, and does discharge, a debt owed to the [recipient] (or a principal on whose behalf he is authorised to receive the payment) by the payer or by a third party by whom he is authorised to discharge the debt; or (c) the [recipient] has changed his position in good faith, or is deemed in law to have done so.\textsuperscript{158}

\textit{Simms} itself was concerned with a situation where the payor

\textsuperscript{154} Cf. ss. 60(3) (negotiation of a bill payable to order by the holder’s endorsement) and 49(1) (a forged signature is inoperative).

\textsuperscript{155} Under s. 167 such events put an end to “[t]he duty and authority of a bank to pay a cheque drawn on it by its customer”.

\textsuperscript{156} This rule is further discussed in Part III(i).


\textsuperscript{158} \textit{Simms}, supra, footnote 150 at p. 232.
bank erroneously overlooked an effective countermand and paid the cheque. Applying his summary to these particular facts, Goff J. concluded that the payor bank was entitled to recover the amount of the cheque from the recipient. The crucial question was whether the payment was with or without a mandate. Payment over an effective countermand is without a mandate.\textsuperscript{159} As such it does not discharge the drawer's debt owed to the recipient so as to fall into exception (2)(b) of Mr. Justice Goff's summary.\textsuperscript{160} In another situation however:

\ldots where the bank pays in the mistaken belief that there are sufficient funds or overdraft facilities to meet the cheque \ldots the effect of the bank's payment is to accept the customer's request for overdraft facilities; the payment is therefore within the bank's mandate, with the result that not only is the bank entitled to have recourse to its customer, but the customer's obligation to the [recipient] is discharged. It follows that the [recipient] has given consideration for the payment; with the consequence that, although the payment has been caused by the bank's mistake, the money is irrecoverable from the [recipient] unless the transaction of payment is itself set aside.\textsuperscript{161}

I will first critically examine the holding in Simms with respect to the problem of payment over an effective countermand. Next, I will discuss the application of Simms to the case where a drawee bank erroneously pays a cheque bearing a forged drawer's signature. In each situation I will outline alternative solutions and make my own suggestions for statutory reform.

(ii) Payment over customer's countermand

In connection with payment over an effective countermand, the doctrinal basis of Simms is not free from doubts. Particularly troublesome is Mr. Justice Goff's reasoning that since payment by the payor bank was made without the customer's authority, it did not discharge the customer's debt owed to the recipient.\textsuperscript{162} This overlooks the position in equity "under which a person who

\textsuperscript{159} Except that it can be regarded as payment under apparent authority: Goode, "The Bank's Right to Recover Money Paid on a Stopped Payment", 97 L.Q.R. 254 (1981), at p. 258.

\textsuperscript{160} Previous case law on recovery of payment made over a customer's countermand is reviewed in Sanda Rodgers Magnet, "Inaccurate or Ambiguous Countermand and Payment Over Countermand", 4 C.B.L.J. 297 (1979-80), at p. 311. The case law is also reviewed by Reynolds, "Countermand and Cheques", 15 U. of B.C. L. Rev. 341 (1981), at p. 359.

\textsuperscript{161} Simms, supra, footnote 150 at p. 236.

\textsuperscript{162} Text following footnote 158, supra.
pays the debt of another without authority may be allowed the advantage of the payment”). Such “equitable doctrines” were explicitly relied upon in Shapera v. Toronto-Dominion Bank. The court in that case dismissed an action of a customer against a drawee bank which erroneously had paid on a countermanded cheque, inter alia, because “payment discharged a legal liability of the customer [to the recipient]”.

The latter case thus appears to mean that whenever the customer has no defences against the recipient or is sued by a holder in due course who overcomes the customer’s defences, payment by the payor bank discharges the customer’s liability under principles of equity. While Shapera dealt with the position of the payor bank vis-à-vis its customer, the inevitable implication is that a valid discharge of the customer’s debt owed to the recipient is a bar to the payor bank’s recovery from the recipient. Stated otherwise, it is only where the customer could effectively assert defences against the recipient that the payor bank may not charge the customer’s account and may recover from the recipient. This is markedly different from Simms under which the payor bank is never permitted to charge the customer’s account and may always recover from the recipient irrespective of the latter’s entitlement from the customer.

The UCC adopts in s. 4-407 a solution which corresponds with the one suggested in Shapera. The provision reads as follows:

If a payor bank has paid an item over the stop payment order of the drawer ... or otherwise under circumstances giving a basis for objection by the drawer ... to prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment ... the payor bank shall be subrogated to the rights

(a) of any holder in due course ... against the drawer ... and

(b) of the payee or any other holder ... against the drawer ... either on the [cheque] or under the transaction out of which the [cheque] arose; and

(c) of the drawer ... against the payee or any other holder ... with respect to the transaction out of which the [cheque] arose.

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164 Ibid.

165 Ibid.

166 BEA, s. 74(b): “a holder in due course ... holds the bill free from any defect of title of prior parties, as well as from mere personal defences available to prior parties among themselves.”
Under this provision, it is the entitlement of the recipient as against the drawer which determines the payor bank’s rights. Thus, where payment is made either to a holder in due course or to a payee entitled to enforce payment as against the drawer, the drawee bank may debit the drawer’s account (subsecs. (a) and (b)). In such a case the bank is barred from recovering from the recipient. Where the drawer has valid defences, effective as against the recipient, the drawee bank may recover from the latter under subsec. (c). Indeed, by using the term “subrogated”, UCC 4-407 explicitly adopts the “equitable doctrines” which underly the holding in \textit{Shapera}.\textsuperscript{167}

From a policy perspective, \textit{Shapera} seems to represent a better view than \textit{Simms}.\textsuperscript{168} In the latter case, Goff J. was “happy to be able to reach the conclusion that the money is recoverable by the plaintiff bank”, because the dispute between the customer and the recipient would be better determined in an action as between themselves.\textsuperscript{169} Unfortunately he failed to consider the goal of endowing payment of a cheque with finality, thereby assimilating the use of cheques to that of money. Nor did he seem to appreciate that where the recipient is a holder in due course the customer’s defences against the payee cannot be raised, so that in any event the dispute between the immediate parties to the transaction underlying the cheque will not be an issue in the action against the recipient.

However, in the final analysis I would not suggest the adoption of the \textit{Shapera}/UCC solution either. Its effect is to protect the payor bank from the consequences of its failure to follow the customer’s effective stop-payment order. The payor bank may debit the countermanding customer’s account and take its chances as to the lack of defences on the part of its customer as against the holder’s action. When the cheque is collected through a depositary bank, the latter’s holder in due course status under s. 165(3)\textsuperscript{170} effectively eliminates any risk involved in such a course of action. Having debited the countermanding customer’s

\textsuperscript{167}For the use of subrogation in a similar context, see B. Liggett (Liverpool), Ltd. v. Barclays Bank, Ltd., [1928] 1 K.B. 48 at p. 64, directly relied upon in \textit{Shapera}, supra, footnote 163 at pp. 127-8 D.L.R., p. 448 W.W.R.
\textsuperscript{168}The subrogation solution is also supported by Goode, \textit{supra}, footnote 159 at p. 263.
\textsuperscript{169}Simms, \textit{supra}, footnote 150 at pp. 239-40.
\textsuperscript{170}For the depositary bank’s holder in due course status under s. 165(3), see the discussion at the end of Part I(i), \textit{supra}.
account, the payor bank can always defend the customer's action by being subrogated to the depositary bank's rights under s. 165(3).

A sound legislative solution should eliminate the subrogation of the payor bank to the depositary bank's position. It should also impose the credit strain on the payor bank until final entitlement to the funds is determined as between the drawer and the holder. By leaving the funds with the recipient, such a solution is consistent with the goal of assimilating the use of cheques to that of money. By not depriving the drawer of the use of these funds, the solution is also consistent with the effectiveness of his stop-payment order. The proposed solution puts the credit strain on the payor bank, the party whose fault infringed upon the drawer's right. Against Mr. Justice Goff's wishes, the payor bank will find itself involved in the customer-recipient's dispute, but its involvement is the result of its own error.

Along these lines, my proposed legislative solution to the mistaken payment over an effective countermand issue is the following:

1. Notwithstanding any agreement to the contrary, a payor bank which has paid a cheque over an effective stop-payment order of the drawer may not debit the drawer's account with the amount of the cheque.

2. To prevent unjust enrichment and only to the extent necessary to prevent loss to the bank by reason of its payment of the cheque, a payor bank which has paid a cheque in good faith over an effective stop-payment order of the drawer shall be subrogated to the rights
   (a) of the payee, or any other holder of the cheque except for a collecting agent, against the drawer, either on the cheque or on the basic transaction, as if the cheque had not been paid; and
   (b) of the drawer against the payee or any other holder of the cheque with respect to the basic transaction.

3. (a) The rights of the payor bank under subsec. (2) may be enforced by bringing an action against all defendants so that all will be bound by the outcome of the litigation.
   (b) Final judgment against the drawer in an action on the basis of rights under subsec. 2(a) entitles the payor bank

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171 See text and footnote 169, supra.
to debit the drawer's account with the amount of the judgment. Final judgment against any defendant in an action brought on the basis of rights under subsec. 2(b), operates as a final judgment in favour of the drawer as to lack of authority on the part of the payor bank to debit his account with the amount of the drawer's claim under subsec. 2(b).

4. A payor bank which has paid the holder a cheque over an effective stop-payment order of the drawer has no rights but those enumerated in this section.

(iii) Payment of a forged cheque

I will now consider the application of *Simms* to the case in which a drawee bank erroneously pays a cheque bearing a forged drawer's signature. For more than 200 years it has been thought that a drawee pays at his peril and that he cannot recover from a *bona fide* recipient. This is the doctrine of *Price v. Neal*,¹⁷² or the principle of finality of payment. According to Dean Ames:

The rule established by *Price v. Neal*, that a drawee pays (or accepts) at his peril a bill, on which the drawer's signature is forged, has been repeatedly recognized ... Unfortunately, there is not a similar unanimity as to the reason of the rule. The drawee's inability to recover the money paid is often referred to his supposed negligence. He ought ... to know the signature of the drawer ... Another so-called explanation of the rule ... [is] that the drawee is "conclusively presumed to know" or is "estopped to deny", the signature of the drawer ... The holder's right to retain the money paid him by the drawee has sometimes [also] been placed upon the ground, that, in consequence of the payment, he has lost the right to recourse against prior indorsers, which he would have had, in case the bill had been dishonored ... The true principle [is however that] ... as between two persons having equal equities, one of whom must suffer the legal title shall prevail. The holder of the bill of exchange paid away his money when he bought it; the drawee parted with his money when he took up the bill. Each paid in the belief that the bill was genuine. In point of natural justice they are equally meritorious. But the holder has the legal title to the money. A court of equity ... cannot properly interfere to compel the holder to surrender his legal advantage.¹⁷³

Notwithstanding Ames, the explanation which was ultimately given by English courts was based upon the loss of recourse rights against prior endorsers. As explained below, this represents a serious curtailment of the scope of the rule, for it means that

¹⁷² (1762), 3 Burr. 1354, 97 E.R. 871.
whenever no loss of recourse rights is involved, as where the recipient is the payee on the cheque, the principle of finality of payment does not apply and the payor bank may recover from the recipient.

The leading case is National Westminster Bank Ltd. v. Barclays Bank International Ltd.\(^ {174} \) Here, a blank cheque stolen from a customer of the drawee bank was made payable to one Ismail, and bearing a forged drawer's signature, was delivered to him for good consideration to be given after payment of the cheque. Ismail deposited the cheque in his bank account with another bank and parted with the consideration only after the drawee bank had paid the cheque. It was held that the drawee bank could recover from Ismail. The court rejected the existence of an absolute duty on the part of a payor bank to know the signature of its customer. It further rejected the existence of a duty of care owed by a payor bank to the holder in honouring cheques. The court thus held that a payor bank could recover from a recipient who had not lost a recourse right by virtue of the payor bank's original payment. The court explained and distinguished Price v. Neal by saying that the recipient there was a subsequent endorsee rather than the original payee on the instrument. The fact that the recipient in National Westminster had parted with valuable consideration on the basis of the bank's payment was considered by the court to be immaterial. Payment by a payor bank of an undetectable forged cheque is no representation that the drawer's signature is genuine. It is merely a representation as to the availability of funds in the customer's account. In the absence of negligence, no estoppel by representation could arise on the bank clearing such a cheque whether presented for special collection or cleared in the normal way. Since an endorser is entitled to immediate notice of dishonour (ss. 96 \textit{et seq.}) and is released if he is not given it (s. 96(1)), the holder is entitled to know immediately whether the bill is honoured or dishonoured so that he can give his notice. If the holder is allowed by the drawee to suppose that the bill has been honoured and is deprived of the opportunity to give notice, he is prejudiced by the loss of recourse. Payment by the drawee is final then only when made to a recipient who is under a duty to give notice of dishonour. Where no loss of recourse (by virtue of failure to give a timely notice of dishonour)

\(^{174}\text{[1975] Q.B. 654, per Kerr J. (hereafter "National Westminster")}.\)
is involved, the payor bank is free to go ahead and recover from
the recipient. The only recipient without a recourse right (and
hence without a duty to give notice of dishonour) is, ultimately,
the payee.

This analysis was fully adopted by Goff J. in Simms. 175 Indeed,
it fits his general summary, the loss of recourse being the change
of position within rule 2(c). 176

Consider the position of a depositary bank which collects for a
payee a cheque bearing a forged drawer’s signature. On discov-
ering the forgery, may the payor bank recover from the depos-
itary bank? According to National Westminster, the answer
depends on whether or not the depositary bank has parted with
money to the payee in reliance on the cheque being honoured.
Where the payee has actually collected the proceeds, the depos-
itary bank can successfully raise a defence to the payor bank’s
action “on the basis that as the collecting bank they were in the
same position as agents who have parted with the money to their
principal, so that it is then no longer recoverable from them”. 177
Otherwise, i.e., where the payee has not collected the proceeds
of the forged cheque, the payor bank has a good cause of action
against the depositary bank. In National Westminster, the amount
of the forged cheque remained in the payee’s account. The case
thus fell within the latter category and judgment was given
against the depositary bank as well.

Where a payor bank recovers from the depositary bank which
has not parted with the proceeds of the forged cheque, may the
latter debit the payee’s account? While the court in National
Westminster did not discuss this question, it implicitly assumed
that the depositary bank has such a right. I agree. The right is not
based on the payee’s contract as an endorser. 178 Presumably it
emerges from restitution law. Not suing its depositor-customer on
the endorser’s contract, the depositary bank is not strictly obliged
to give a statutory notice of dishonour, 179 and therefore does not
lose its recourse rights on the late discovery of the forgery.

The treatment of the depositary bank’s position in National

176 Footnote 158 and text, supra.
W.W.R. 97 at p. 103 (B.C.C.A.).
179 Ibid.
Westminster seems to me to be satisfactory. At the same time I have serious difficulties with the principal holding of the case in relation to a mistaken payment of a cheque bearing a forged drawer’s signature. To begin with, as indicated by Ames, there is nothing in Price v. Neal which compels the doctrinal analysis given in National Westminster and adopted in Simms. In fact, a change of position requirement as the basis for the recipient’s defence against the payor bank is incongruous in light of s. 129(a). Under the latter provision an acceptor of a bill “is precluded from denying to a holder in due course . . . the genuineness of [the drawer’s] signature”. No change of position is thus required when a holder in due course purports to enforce payment against an acceptor of a forged cheque. It would therefore be anomalous to subject a holder in due course to a change of position requirement where he defends against an action by a payor bank to recover payment made on a forged cheque. But even if finality of payment applies only as against a recipient who has changed his position in good faith, as suggested by rule 2(c) of the general principles applicable to recovery of money paid under mistake of fact, National Westminster is indefensible. First, it is hard to see why the endorsee’s loss of recourse rights against prior parties should be singled out as the only change of position effective as a defence against the payor bank. In National Westminster, the recipient was the payee of the cheque who parted with consideration on the actual payment of the cheque; this should be a sufficient change of position. Secondly, an endorsee who is paid on a forged cheque does not necessarily lose his recourse rights against prior parties on the subsequent dishonour of the cheque. True, on the dishonour of a bill, notice of dishonour must be given to prior parties “not later than the juridical or business day next following the dishonour of the bill”. Without such notice, recourse against prior parties is lost. Yet, under s. 105(1) “[d]elay . . . is excused where . . . caused

180 Footnote 173 and text, supra.
181 Supra, footnote 172.
182 Footnotes 174, 175 and text, supra.
183 Footnote 175, supra.
184 Footnote 158 and text, supra.
185 Text which follows footnote 174, supra.
186 But cf. the court’s reasoning as explained ibid.
187 BEA, ss. 96(1) and 97(a).
by circumstances beyond the control of the party giving notice". It seems conceivable that delay in giving the notice caused by the payor bank's original payment of the cheque falls into this category. It should not cause the endorsee to lose his recourse rights. 188

In sum, National Westminster is far from persuasive. First, explaining Price v. Neal on the basis of the recipient's change of position is not convincing. Secondly, it is unclear why loss of recourse rights is the only acceptable change of position. Thirdly, it is doubtful whether any loss of recourse rights is actually involved.

Last but not least, limiting finality of payment only to the case of a change of position is not acceptable as a matter of policy. In support of the principle of finality of payment it is frequently said that "[t]he rule in Price v. Neal places the risk of forgery of the drawing on the drawee bank, which is the proper party to bear that risk, it being an integral part of its function and risk against which it can insure itself, thereby distributing the burden among the clients making use of its services." 189 In this framework, the change of position limitation appears to be unwarranted.

It is worthwhile at this juncture to examine the legislative solution adopted by the American UCC with respect to the drawee bank's right to recover from the recipient the amount of a cheque bearing a forged drawer's signature paid by mistake of fact. Under UCC 3-418, "payment . . . is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment." By its own terms, 190 the provision does not apply to payment of a cheque bearing a forged endorsement, a situation for which other provisions 191 provide a

188 In connection with these points of criticism, I share the view of Professor Scott, p. 129 of his (unpublished) Law of Banking and Negotiable Instruments Course Notes and Syllabus (1977).

189 Barak, supra, footnote 25 at p. 46.

190 UCC 3-418 reads in full: Except for recovery of bank payments as provided in the Article on Bank Deposits and Collections (Article 4) and except for liability for breach of warranty on presentment under the preceding section, payment or acceptance of any instrument is final in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.

For the relation between this provision and Article 4, see Colombo, "Commercial Paper and Forgery: Broader Liability for Banks?" [1981] U. Ill. L. F. 813. For "the preceding section" see footnotes 191 and 192 and text, infra.

191 UCC 3-417(1) and 4-207(1).
solution similar to the one adopted by s. 50(1) of the Canadian Act. According to Official Comment, UCC 3-418 "follows the rule of Price v. Neal . . . under which a drawee who . . . pays an instrument on which the signature of the drawer is forged . . . cannot recover back his payment." It is, however, apparent from the language of the provision that except for when he is a holder in due course, a change of position is an essential element of the recipient's defence. At the same time, the provision does not go so far as to limit finality of payment to the case of a subsequent endorsee whose alleged change of position is the loss of recourse rights against prior parties. Furthermore, under UCC 3-302(2), "[a] payee may be a holder in due course", provided of course, he took the instrument in good faith and for value as generally required under UCC 3-302(1). In other words, there is no question that payee Ismail in National Westminster would have been protected under UCC 3-418. He definitely changed his position on the basis of payment. Arguably, he could also claim the status of a holder in due course.

I would favour a legislative solution providing for the finality of payment on a cheque bearing a forged drawer's signature. Finality of payment should benefit every bona fide recipient, not just a holder in due course. I would thus support the adoption of a provision modelled on UCC 3-418 without the change of position requirement presently imposed on one not a holder in due course. Such a solution endows payment of a cheque with finality and allocates the loss to the payor bank which is the best risk-bearer among the parties involved.

III. Allocation of Forgery Losses

A sound scheme allocating forgery losses should be aimed at achieving loss reduction and loss distribution while not undermining the fundamental policies underlying the use of negotiable instruments as payment devices. These fundamental policies are the free circulation of commercial paper and the finality of

192 See text subsequent to footnote 155, supra.
193 See text which follows footnote 174, supra.
194 See footnotes 185 and 186 and text, supra.
195 But cf. First National City Bank v. Altman, 3 UCC Rep. 815 (N.Y. Sup. Ct. 1966), affd 27 App. Div. 2d 706. In that case, the court did not consider the possibility that a payee in Ismail's position could be a holder in due course.
payment. It has, however, been observed that “[t]he allocation of losses resulting from check forgeries stems from a complex and interrelated body of statutory and case law” and that “the law allocates losses ... according to a set of mechanical doctrines”. Allocation to an innocent party depends first upon which signature has been forged. Secondly, allocation is determined by estoppel principles. In general, a forged signature does not charge the person whose signature has been forged with liability on the cheque. This emerges from s. 49(1) which provides that a “forged ... signature is wholly inoperative”, as well as from s. 131 under which “[n]o person is liable ... [on the bill] who has not signed it”.

In dealing with the responsiveness of the scheme to policy considerations, I will first deal with the allocation of losses as determined by the type of signature forged. Then I will consider the allocation of losses as affected by some aspects of estoppel principles, or preclusions from setting up forgery. Finally, I will examine the possibility of circumventing the estoppel exception and the responsiveness of this pursuit to policy considerations.

(i) The basic scheme

According to the above-mentioned ss. 49(1) and 131, a customer of a drawee bank whose drawer’s signature has been forged is not liable on the cheque. Nor is he liable to the drawee bank where it has erroneously paid the cheque. Where the forgery of the drawer’s signature is detected before payment, these provisions allocate the loss to the payee who has taken the cheque from the forger. Where forgery is detected after payment, the payor bank may bear the loss under the doctrine of Price v. Neal, discussed in Part II of this paper.

A forged endorser’s signature constitutes a breach in the chain of title to the cheque: “no right to retain the bill or to give a discharge therefor or to enforce payment thereof against any party thereto can be acquired through or under [a forged] signature” (s. 49(1)). A forged endorsement does not pass title or lawful possession to the transferee. Title and right to possession

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remain with the original holder whose signature has been forged. A transferee who derives his title, directly or indirectly, through a forged endorsement is not a "holder" in relation to parties whose signatures on the bill preceded the forgery because one cannot be "holder" without "negotiation" (s. 60(1)). Since negotiation of an order instrument is by "the endorsement of the holder" (s. 60(3)), the forger, and hence anyone deriving title from him, is not a "holder." Since a holder in due course must be a holder (s. 56(1)), so one who takes a cheque subsequent to a forged endorsement cannot be a "holder in due course" in relation to parties whose signatures preceded the forgery.199

The "true owner", namely the one from whom the cheque has been stolen and whose endorsement has been forged, may sue in conversion or in money had and received, any person through whose hands the cheque has passed subsequent to the forgery. The defendant need not necessarily be the one in possession at the time of the action. By virtue of s. 133, a defendant who is not the payor bank may sue any prior transferee who took the instrument subsequent to the forgery: an endorser of a bill is precluded from denying "the genuineness and regularity ... of ... all previous endorsements" (s. 133(b)), as well as that "at the time of his endorsement ... he had ... a good title" (s. 133(c)). These preclusions effectively run in favour of all transferees subsequent to the taker from the forger.200 On their strength, "the person in possession of a bill bearing a forged indorsement is considered a holder against every party who signed the bill after the forgery of the indorsement".201 The one who ultimately bears the loss is the party who took the cheque directly from the forger: he is liable on his signature to subsequent parties and is liable in

198 See in general, Part I, supra.
200 The s. 133(b) preclusion runs in favour of a "holder in due course". The s. 133(c) preclusion runs in favour of an "immediate or a subsequent endorsee". In relation to prior parties who signed the instrument subsequent to a forged endorsement, the possessor of the bill is an "immediate or ... subsequent endorsee" as well as (depending on his compliance with the good faith purchase requirement of s. 56(1)) a "holder in due course". The s. 133(b) preclusion (running only in favour of a holder in due course) includes also the genuineness and regularity of the drawer's signature.
conversion or for money had and received to the one from whom the bill was stolen and whose signature has been forged. No cause of action runs in his favour.

The preclusions under s. 133(b) and (c) do not run in favour of the payor bank. Where a cheque bearing a forged endorsement has erroneously been paid, and the person from whom the cheque was stolen and whose endorsement has been forged (the "true owner") sues the payor-drawee in conversion or in money had and received, the latter bank's remedy is provided for by s. 50(1). Under this section, where a cheque bearing a forged endorsement is paid "in good faith and in the ordinary course of business", the payor bank "has the right to recover the amount so paid from the person to whom it was so paid or from any endorser who has endorsed the bill subsequently to the forged ... endorsement". The defendant may sue prior endorsers who took the instrument subsequent to the forgery either on the basis of the explicit remedy provided for by s. 50(2) or on the basis of the s. 133(b) and (c) preclusions. The one who ultimately bears the loss is, again, the taker from the forger. He does not have a "prior endorser subsequent to the forged ... endorsement" whom he can sue under s. 50(2). Nor can he find any intermediary party against whom he can invoke the estoppel under s. 133(b) and (c).

In fact, this scheme of allocation of forgery losses is not arbitrary or mechanical. The rationale behind the rule as to the freedom from liability of the party whose signature has been forged is obvious. The doctrine of Price v. Neal as to the finality of payment of cheques bearing a forged drawer's signature is basically responsive to policy considerations. What is subject to criticism in connection with the doctrine is, rather, the recent trend to restrict its application.

Similarly, the scheme allocating forged endorsement losses has its own logic. The scheme goes back to Mead v. Young where Buller J. reasoned that the transferee in possession subsequent to the forgery who cannot recover on the bill against parties prior to the forgery,

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202 Section 50(2) provides:
(2) Any such person or endorser from whom such amount has been recovered [under s. 50(1)] has the like right of recovery against any prior endorser subsequent to the forged or unauthorized endorsement.

203 Notwithstanding text and footnote 196, supra.

204 See in general, Part II, supra.

205 (1790), 4 T.R. 28, 100 E.R. 876.
... will be induced to prosecute the forger; and that would be the case even if [the instrument] had passed through several hands, because each indorser would trace it up to the person from whom he received it, and at last it would come to him who had been guilty of the forgery: whereas if the [possessor] succeed in this action, he will have no inducement to prosecute for the forgery ... 206

By allocating the loss to the taker from the forger, the scheme encourages a transferee to inquire into the title of his transferor. The policy behind the scheme is, therefore, one of loss reduction.

Opposite policy considerations were raised in Mead v. Young by Chief Justice Kenyon. In his dissent he noted that the majority's view "will put an insuperable clog on this species of property" and stressed the heavy "burden on persons taking bills of exchange to require proof of an indorsee that the person from whom he received the bill was the real payee". 207

It is obvious that the majority view which was subsequently incorporated into the Canadian Act, 208 while having its own logic, is inconsistent with the policies of free circulation of commercial paper and finality of payment. 209 A good faith purchase of commercial paper does not secure the right to obtain payment. Similarly, even where payment is made, it does not shield the recipient from a subsequent restitutionary claim by the payor. This state of the law is specifically rejected in civil law by the Geneva Uniform Law (ULB). According to that law, the person who is in possession of a bill deriving his title through an uninterrupted series of endorsements may enforce the instrument also against parties prior to the forged endorsement. The risk of a forged endorsement falls on the person who lost the instrument. 210 Providing a bona fide purchaser with good title and protecting him against a restitutionary claim by the payor, the ULB rule is consistent with the free circulation as well as with the finality of payment policies. However, since it does not

206 Ibid., at pp. 31-2.
207 Ibid., at p. 30.
208 The rule under the U.K. Act is not identical. Cf. text and footnotes 236-7, infra.
209 Cf. Perini Corp. v. The First National Bank of Habersham County, 553 F. 2d 398 (U.S.C.A. 5th Cir. 1977) dealing (at pp. 405-6) with the same inconsistency from an American perspective.
210 See in general: Vis, "Forged Indorsements", 27 Am. J. Comp. L. 547 (1979), at p. 550. The adoption of the ULB rule in Canada is recommended in Baxter, supra, footnote 120 at p. 78.
encourage a transferee to inquire into his transferor’s title, the rule is inconsistent with the policy of loss reduction. An interesting compromise position has been advanced by the UNCITRAL draft.\(^{211}\) The draft adopted the ULB rule but added a cause of action in favour of the “true owner” as against the taker from the forger.\(^{212}\) By protecting transferees who took the paper subsequent to the taker from the forger, it follows the ULB rule, thereby enhancing the free circulation and finality policies. At the same time, the true owner’s cause of action against the taker from the forger secures the policy of loss reduction advanced by Buller J. and adopted by the Canadian Act. I believe that such a compromise position, or middle rule, should be seriously considered in any reform of the BEA.

Both the Act and the UNCITRAL draft place forged endorsement losses on the taker from the forger. Where the taker is a bank, whether the payor or a collecting bank, this result is consistent with the policy of loss distribution, since a bank can absorb the loss and distribute it among its customers, with or without the aid of insurance. Where the taker from the forger is not a bank, the policy of loss distribution is not enhanced by this scheme of allocating forgery losses. In such a case, loss distribution can be achieved by private insurance. Those dealing with commercial paper should insure themselves against the risk of taking instruments bearing forged endorsements.\(^{213}\)

(ii) **Preclusion under s. 49(1)**

The responsiveness to policy considerations of the scheme allocating forgery losses has proved inadequate in conjunction with the rules dealing with the preclusion from setting up forgery.

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\(^{212}\) See in general: Vis, *supra*, footnote 210 at p. 553. The draft does not cover cheques.

\(^{213}\) To secure a broader loss distribution, insurance should also cover the risk of a forged drawer’s signature. This is so because where the forgery of the drawer’s signature is detected before payment of the cheque, the loss falls not on a bank but on the payee who took the cheque from the forger. See the first paragraph in the present section, *supra*. For an American perspective on forgery insurance and its role in the scheme allocating forgery losses, see Farnsworth, “Insurance Against Check Forgery”, 60 Col. L. Rev. 284 (1960).
These rules derive from s. 49(1): "where a signature on a bill is forged ... the forged ... signature is wholly inoperative ... unless the party against whom it is sought to retain or enforce payment of the bill is precluded from setting up the forgery". As discussed below, the rules governing estoppel by negligence, and their relationship with those governing estoppel by contract, have proved problematic.

The authority for the drawer's duty of care toward the drawee is Young v. Grote.\textsuperscript{214} It was held in that case that a drawee bank may debit the account of the drawer for the full amount of a cheque that was negligently drawn so as to permit its subsequent alteration by the insertion of words and figures without erasures. For some time, the real meaning and even the authority of the case were doubted. It was questioned whether the case had been decided on the basis of the payor bank's apparent authority, the drawer's duty of care in favour of all takers of a negotiable instrument, or the existence of a contractual duty to take care owed by a depositor to his bank with respect to cheques.\textsuperscript{215} In Colonial Bank of Australasia Ltd. v. Marshall,\textsuperscript{216} the Privy Council treated Young v. Grote as no longer good law. The latter's authority was fully re-established by the House of Lords in London Joint Stock Bank Ltd. v. Macmillan and Arthur,\textsuperscript{217} where it was stated that the "sole ground upon which Young v. Grote was decided ... was that Young was a customer of the bank owing to the bank the duty of drawing his cheque with reasonable care".\textsuperscript{218} It is fundamental that estoppel by negligence presupposes the existence of a duty of care.\textsuperscript{219}

Unfortunately, English courts have confined the drawer's duty of care to the customer-drawee bank relationship. The duty cannot be invoked in favour of a subsequent holder including a

\textsuperscript{214} (1827), 4 Bing. 253, 130 E.R. 764.
\textsuperscript{215} See in general, Note, "Careless Spaces on Negotiable Instruments", 31 Harv. L. Rev. 779 (1918).
\textsuperscript{216} [1906] A.C. 559 (P.C.). For a contemporary valid criticism, see Beven, "Young v. Grote", 23 L.Q.R. 390 (1907).
\textsuperscript{217} [1918] A.C. 777.
\textsuperscript{218} Ibid., at p. 793, per Lord Finlay L.C.
collecting bank. Furthermore, the duty of care has been confined to acts or omissions with regard to the drawing and signing of cheques: "the negligence must be in the transaction itself, that is, in the manner in which the cheque is drawn". 220 No duty has been recognized in the English cases, even towards the drawee bank, to exercise reasonable care (a) in the general course of carrying on business, including the selection of employees, so as to detect and prevent forgeries, or (b) in the examination of periodical bank statements, so as to discover and report forgeries and prevent a repetition thereof. A drawer is also not required to conduct his business in such a way as to prevent the forgery of the payee's endorsement by the drawer's employee before the delivery of the cheque to the payee. 221

The application of these rules can be demonstrated in the following examples:

(1) A cheque payable to the order of Corporation B is stolen from it by its unfaithful employee. Taking advantage of careless office procedures, the unfaithful employee also steals the corporate stamp. With the aid of the stamp and by forging the signatures of the authorized signing officers, he endorses the cheque to his order. He deposits the cheque into his bank account with a depositary bank, and draws funds against it. Depositary bank presents the cheque to the drawee bank and obtains payment. In the absence of estoppel by negligence, the loss falls on the depositary bank: it is liable to the drawee under s. 50(2) and lacks any cause of action.

(2) A payroll clerk, whose normal duty is to prepare wage or salary cheques for employees of a company, perpetrates a fraud by including among the cheques presented to the authorized signing officers of the company, a number of cheques payable to persons who were not owed any wages, some being former employees, and some having names invented by the fraudulent clerk. The fraudulent clerk extracts these cheques, forges the endorsements and obtains payment from the company's bank, which debits the company's account accordingly. 222 The allocation of the loss 220 London Joint Stock Bank Ltd. v. Macmillan and Arthur, supra, footnote 217 at p. 795.
221 See, e.g., Chalmers, supra, footnote 15 at p. 206.
as between the company and the bank depends on the proper construction of s. 21(5). That section provides that a bill whose payee is "a fictitious or non-existing person ... may be treated as payable to bearer". This means that where the payee is "fictitious or non-existing" the loss falls on the company since no endorsement is required to negotiate a bearer instrument (s. 60(2)). The possessor of such a bill is a holder (ss. 2, 60(2)) who may be a holder in due course, and as such is not liable to the person from whom the bill was stolen. Payment to him as a "holder" discharges the bill and entitles the payor bank to debit the account of its customer (s. 139(2)).

Technical and arbitrary rules have developed in the case law to determine whether a payee is a "fictitious or non-existing person" within the meaning of s. 21(5). These rules provide that a payee who is either a creature of imagination or a dead person is "non-existing". A payee who is a real person and whose name is inserted by the drawer by way of pretence, with no intention that he will receive payment is "fictitious". A payee who is a real person and is intended by the drawer to receive payment, but whose name is inserted because of a third person's fraud who falsely represents that the drawer is indebted to such payee, is neither "fictitious" nor "non-existing". The intention of the drawer or its signing officer determines whether the payee is "fictitious", but not whether he is "non-existing". "Existence or non-existence is a question of fact, not relevant to anybody's mind or intention."225

In our example, according to these rules, only cheques payable to payees whose names were invented by the fraudulent clerk fall within s. 21(5). Such payees are "non-existing". Cheques payable to former employees are not payable to "fictitious" or "non-existing" persons, so the loss with respect to them falls on the drawee bank.226 This indeed

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225 Falconbridge, supra, footnote 3 at p. 481.
226 This indeed was the decision of the Supreme Court of Canada in Royal Bank of Canada v. Concrete Column Clamps (1961) Ltd., supra, footnote 222.
is an arbitrary classification. Within the framework of a drawer's duty of care, the company ought to be found liable for the amounts of all the cheques.227

(3) F is the bookkeeper of Corporation C. From time to time he takes a blank cheque from the corporation's cheque book, makes it payable to himself and, after forging the signatures of the signing officers of the corporation and imprinting the corporate stamp on the cheque, deposits it in his bank account with Depositary Bank. Amounts so paid are later withdrawn by F. Each cheque (bearing the drawer's forged signature) is paid to Depositary Bank by the drawee Payor Bank. Monthly statements, together with all cancelled cheques, are sent by Payor Bank to Corporation C where they are brought only to the attention of bookkeeper F. The scheme works for years. When it is finally discovered, in the absence of estoppel, the loss is borne by Payor Bank: payment of a cheque bearing a forged drawer's signature does not entitle the payor bank to debit its customer's account.

The courts have purported to avoid this result and shift the loss to the customer (Corporation C in our example), by giving liberal construction to a verification agreement between a customer and a drawee bank. In Arrow Transfer Co. Ltd. v. Royal Bank of Canada,228 the majority of the Supreme Court of Canada (per Martland J.) read such an agreement as precluding the customer from setting up the forgery of his own signature ("estoppel by contract"). The agreement in that case used broad language: it required the customer to notify the bank of any debits wrongly made in the account within a specified period after the receipt of each periodical statement of account from the bank. Unless the customer gave such notification, at the end of the stipulated period the account presented by the bank became conclusive. In his minority opinion, Laskin J. (as he then was) held that the language of the agreement was not sufficiently unambiguous to protect the bank in the event of a forged drawer's signature. The other justices relied on the verification

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agreement as a means of circumventing the effect of their own refusal to recognize a customer's duty of care to examine bank statements and to report forgeries that should have been discovered by such an examination.229

I am not satisfied with this "estoppel by contract" theory for the following three reasons:

(a) The theory is quite artificial and its foundation is unconvincing. As a general rule, a court will not shift loss from a banker to a depositor merely on the basis of a broadly drafted exemption clause in a standard form contract which is not even tailored to meet the specific grievance sought to be remedied. I agree with Laskin J. that the "express reference [of s. 49(1)] to a forged signature appears ... to oblige those who would contract out to make it quite clear that forgery of a drawer's signature ... is within the scope of the protection that a drawee bank has obtained under its self-protecting contractual arrangements".230 My view is that the court read the verification agreement so broadly only because it had been convinced by the policies served by this reading. It is more natural to implement these policies irrespective of the contractual provision on the basis of estoppel by negligence.

(b) The estoppel by contract theory is less responsive to policy considerations than is the estoppel by negligence theory. Under the verification agreement, when the customer finally detects the fraud and informs the bank of its existence, he will not be responsible for amounts of forged cheques included in the last periodical statement with respect to which notice was timely given. This is so even though the customer's failure to detect the previous forgeries substantially contributed to this recent loss. By the same token, the effect of the verification agreement is to charge the customer with liability even with respect to the first statement containing forged cheques. Where the customer's negligence is only in not detecting forgeries, the opposite result is accomplished under the estoppel by negligence.

229 As to the position of Laskin J. on the negligence question, see footnotes 238-9 and text, infra.

230 Supra, footnote 228 at p. 96 D.L.R., p. 867 S.C.R.
negligence theory. The customer will not be responsible for forged cheques included in the first statement since his negligence in failing to detect the forgery did not cause the loss. The customer will, however, be answerable for the cheques included in the last statement because the loss in connection with this statement was caused by his failure to prevent the repetition of the forgery by declining to detect forgeries in connection with the previous statements. The customer’s prompt notification after the last statement prevents further loss, but is not an answer to a claim based on the customer’s previous failures to detect.

(c) Estoppel by contract is only a partial solution: it does not shift the loss to the customer where his negligence causes a forged endorsement (see examples (1) and (2), supra).

The results in all three examples do not reflect sound policies. Holding a bank liable for losses to which a customer’s negligence has substantially contributed, while accomplishing loss distribution, does not enhance loss reduction. On the other hand, allocation of forgery losses to a negligent party who could have prevented the loss by exercising due care is consistent with the loss reduction policy. Under these circumstances, loss distribution could be better achieved by private insurance.

It is possible to speculate on why the courts have declined to charge bank customers and holders of negotiable instruments with a duty of care in connection with the prevention or detection of forgeries. One can assume that the refusal to impose a duty on a bank customer to examine bank statements with reasonable care and to report erroneous debits within a reasonable time was originally premised on the assumption that a customer was under no duty to organize his business so that forgery of cheques could not take place.231 These early decisions were given when the authority and scope of Young v. Grote232 were doubted,233 and “before the MacMillan case234 had brought out the duty of care that the customer owes to his banker”.235 Unfortunately, the

232 Supra, footnote 214.
233 See in general, footnotes 215-16 and text, supra.
234 Supra, footnote 217.
change in status of *Young v. Grote* has not prompted a re-
evaluation of the rules establishing the customer’s absence of a
duty to examine bank statements.

As for the issue of improper office management which enables
the creation of forged endorsements, I have expressed my view
elsewhere that the existence of s. 60 of the United Kingdom BEA
could be the reason why the courts have not found a duty of care
in that connection.\(^{236}\) Section 60 shifts the loss from the *bona fide*
bank to the last party in possession of the cheque, regardless of
any negligence.\(^{237}\) Being broader in its operation than negligence,
the effect of this section is to make the existence of a duty of care
on the part of the customer irrelevant when considering the
authority of the drawee bank to debit the drawer’s account with
amounts of cheques paid on forged endorsements. The provision,
which has no counterpart in the Canadian Act, could thus be the
cause of the failure to recognize the duty of care which a customer
owes to his bank.

Against this background it is not inconceivable that Canadian
courts will eventually recognize the existence of a duty of care in
connection with cheque forgeries. In fact, the process is well
under way. The minority opinion of Laskin J. (as he then was) in
*Arrow Transfer Co. Ltd. v. Royal Bank of Canada*\(^{238}\) represents a
significant turning point. In that case, Laskin J. did “not think it
[was] too late to fasten upon bank customers... a duty to
examine bank statements with reasonable care and to report
account discrepancies within a reasonable time”.\(^{239}\) On the facts
of the case, Laskin J. found the customer negligent in employing

\(^{236}\) *Supra*, footnote 227 at pp. 427-8.

\(^{237}\) Section 60 of the United Kingdom BEA reads as follows:

> 60. When a bill payable to order on demand is drawn on a banker, and the
> banker on whom it is drawn pays the bill in good faith and in the ordinary course
> of business, it is not incumbent on the banker to show that the indorsement of the
> payee or any subsequent indorsement was made by or under the authority of the
> person whose indorsement it purports to be, and the banker is deemed to have
> paid the bill in due course, although such indorsement has been forged or made
> without authority.

Whenever a bank pays a bill in due course under the terms of this provision, it is
entitled to debit the drawer’s account: *Charles v. Blackwell* (1876), 1 C.P.D. 548
(H.C.J.), affd 2 C.P.D. 151 (C.A.). A concise history of s. 60 together with a rationale
thereto is to be found in Kessler, “Forged Indorsements”, 47 Yale L.J. 863 (1938), at


an untrustworthy employee in a sensitive position as well as in employing inadequate procedures for discovering fraud. Other opinions in this direction include the dissent of Spence J. in *Royal Bank of Canada v. Concrete Column Clamps (1961) Ltd.* and the case of *Number 10 Management Ltd. v. Royal Bank of Canada.* In the former, Spence J. was prepared to find a drawer liable for the loss caused by the forgery of the payee's endorsement by a dishonest clerk of the drawer on the basis that "it would have been quite easy [for the drawer] in proper office management to have designed sufficient methods of checking and verifying to have defeated [the drawer's dishonest clerk's] scheme". In the latter, Monnin J.A. of the Manitoba Court of Appeal spoke of "a duty on a bank's customer to examine bank documents regularly and to report discrepancies in such documents within a reasonable time of any discovery of error or forgeries".

It remains to be seen whether this departure from the traditional restrictive view of the duty of care will gain universal acceptance. An encouraging recent development is *Canadian Pacific Hotels Ltd. v. Bank of Montreal.* Here, the customer's employee in the accounting department forged the customer's signature on cheques taken from the customer's cheque book. These cheques bearing the drawer's forged signature, were paid by the payor bank which debited the customer's account with their amounts. Bank statements were sent periodically to the customer where they were checked only by the forger. When the customer found out that it had been defrauded by its employee, it sued the bank for the amounts of the forged cheques. Its action was dismissed even though no verification agreement governed the customer-bank relationship. Montgomery J. concluded that "while the relationship between a banker and its customer is contractual[,] the written contract or banking agreement does not necessarily govern the whole relationship". He then held, on

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242 *Supra,* footnote 240 at p. 46 D.L.R., p. 457 S.C.R.
243 *Supra,* footnote 241 at pp. 103-4.
244 A decision which declined to depart from the traditional restrictive view is *Holman v. Royal Bank of Canada* (1975), 58 D.L.R. (3d) 154 (B.C. Co. Ct.).
the basis of "commercial custom", that "a sophisticated commercial customer ... owes a duty to the bank to operate an acceptable internal control system so that both the bank and its customer are jointly engaged in prevention and minimization of losses occurring through forgeries". On the facts of the case, the court had no difficulty in finding breach of duty to the bank by the customer which "was negligent in failing to properly supervise its employee . . . and in failing to follow proper accounting procedure with respect to the bank reconciliations".

It is noteworthy that Canadian Pacific Hotels Ltd. speaks of a duty of care imposed on "a sophisticated commercial customer", owed only to the payor bank. Even if the case is universally accepted, it remains to be seen whether its holding will be extended to recognize a duty of care owed by every customer to all subsequent parties on an instrument. My preference is that a broad duty of care be introduced by statute as was done in Article 3 of the UCC. Noting that "[b]y drawing the instrument and 'setting it afloat upon a sea of strangers' the maker or drawer voluntarily enters into a relation with later holders which justifies his responsibility", the drafters expressly provided a rationale for a duty of care in connection with forgery of negotiable instruments. UCC 3-406 accordingly provides that a person "who by his negligence substantially contributes to . . . the making of an unauthorized signature is precluded from asserting the . . . lack of authority against a holder in due course or against a drawee or other payor". This is in addition to UCC 3-404(1), which corresponds to BEA s. 49(1): "[a]ny unauthorized signature is wholly inoperative as that of the person whose name is signed unless he . . . is precluded from denying it". There is also a specific section providing for a bank customer's duty to examine periodical bank statements (UCC 4-406).

247 Ibid., at p. 573 O.R., p. 532 D.L.R.
248 Ibid., at p. 574 O.R., p. 533 D.L.R.
249 Ibid.
250 Official Comment 2 to UCC 3-406.
251 UCC 4-406 provides in part as follows:

§4-406. Customer's Duty to Discover and Report Unauthorized Signature or Alteration

(1) When a bank sends to its customer a statement of account accompanied by items paid in good faith in support of the debit entries or holds the statement and items pursuant to a request or instructions of its customer or otherwise in a
In the final analysis, I believe that legislative treatment of negligence in connection with the law of bills and notes should be more detailed. The duty of care should be specifically drafted to apply to a selection of employees, to office management and to the examination of bank statements. Separate consideration must be given to the standard and scope of the duty of care imposed on consumers, non-profit organizations, and different types and sizes of business entities. Attention should also be given to the statutory treatment of contributory negligence by a bank. Serious consideration should be given to the insurability of losses imposed on negligent bank customers and the effect of such insurance on the entire scheme of allocation of forgery losses. All these questions involve important refinements of the basic negligence principle which ought not to be neglected in drafting a comprehensive legislative reform.

(iii) The estopped customer and the collecting bank

The last issue to be discussed in conjunction with the responsiveness (to policy considerations) of the scheme allocating forgery losses is the possible cause of action of a drawer or bank customer from whom a cheque is stolen, against a collecting bank.

reasonable manner makes the statement and items available to the customer, the customer must exercise reasonable care and promptness to examine the statement and items to discover his unauthorized signature or any alteration on an item and must notify the bank promptly after discovery thereof.

(2) If the bank establishes that the customer failed with respect to an item to comply with the duties imposed on the customer by subsection (1) the customer is precluded from asserting against the bank

(a) his unauthorized signature or any alteration on the item if the bank also establishes that it suffered a loss by reason of such failure; and

(b) an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank after the first item and statement was available to the customer for a reasonable period not exceeding fourteen calendar days and before the bank receives notification from the customer of any such unauthorized signature or alteration.

(3) The preclusion under subsection (2) does not apply if the customer establishes lack of ordinary care on the part of the bank in paying the item(s).

252 Cf. the $50 ceiling to liability for an unauthorized use of a credit card under s. 133 of the United States Consumer Credit Protection Act (1968), 15 U.S.C. ss. 1601-1691e as amended.

253 Cf. Jackson v. The First National Bank of Memphis, Inc., 403 S.W. 2d 109 (Tenn. App. 1966); Church found not to be negligent in employing a fraudulent financial secretary as well as in failing to supervise him and do proper bank reconciliations.
bank. The cheque might be stolen as a blank cheque, or after having been genuinely signed by the drawer.

The customer whose signature as a drawer was forged, and who had failed to examine properly the bank statements and report the forgery, attempted in Arrow Transfer\textsuperscript{254} as well as in Number 10 Management\textsuperscript{255} to sue the depositary bank in conversion or for money had and received. The attempts failed. The courts reasoned that no valuable assets of the customer (namely cheques having their own value) passed through the collecting bank. As explained by Laskin J., in order to succeed the plaintiff must be the true owner of the piece of paper \textit{qua cheque}, not merely \textit{qua piece of paper}.\textsuperscript{256} In both cases, therefore, a customer who lost against the payor bank was unsuccessful in seeking to shift the loss on to the depositary bank.

A similar result was reached in the United States in \textit{Stone Webster Engineering Corp. v. The First National Bank & Trust Company of Greenfield.}\textsuperscript{257} In that case, a cheque bearing a genuine drawer's signature was stolen from the drawer by an unfaithful employee of the drawer. The unfaithful employee forged the payee's signature and collected the proceeds of the cheque from the payor bank through a depositary bank. In dismissing the drawer's action against the depositary bank the court opined that since the drawer did not have the right of a holder to present the cheque to the drawee for payment, he had no "valuable rights" in it and therefore could not sue in conversion. According to the court, the "value of [the drawer's] rights was limited to the physical paper on which [the cheques] were written".\textsuperscript{258}

It is generally accepted that this state of law is adequately responsive to policy considerations. The question of the negligence of the drawee bank's customer is decided in litigation between him and the drawee bank; having lost in such an action, the customer should not be allowed to shift the loss to the collecting bank.\textsuperscript{259} Furthermore, not being a party to the verifi-

\textsuperscript{254} \textit{Supra}, footnote 238.
\textsuperscript{255} \textit{Supra}, footnote 241.
\textsuperscript{256} \textit{Supra}, footnote 238 at pp. 103-4 D.L.R., p. 876 S.C.R.
\textsuperscript{257} 184 N.E. 2d 358 (Mass. 1962).
\textsuperscript{258} \textit{Ibid.}, at p. 362. For a recent discussion, see Williams, "Sun 'n Sand, Inc. v. United California Bank: A New Approach to the Problem of Drawer v. Collecting Bank", 31 Has. L.J. 221 (1980).
cation agreement, the collecting bank cannot invoke in its favour the customer's "estoppel by contract". To the extent that "estoppel by contract" is the rationale given in Canada to the negligent customer's failure to assert the forgery of his signature, recognition of the conversion or the money had and received action against the collecting bank could therefore always result in a shifting of the loss to the collecting bank, even if it could prove negligence on the part of the drawee bank's customer. This indeed is unjustifiable.

Unfortunately, in *Jervis B. Webb Co. of Canada Ltd. v. Bank of Nova Scotia and Reid*, in a fact situation similar to that of *Stone Webster* (theft of a genuine cheque), an Ontario High Court judge upheld the drawer's action against the collecting bank in conversion as well as for money had and received. The decision is unconvincing as a matter of legal analysis. None of the authorities relied on by Fraser J. compelled the result he reached. Needless to say, the decision is inconsistent with the policy considerations as discussed above. The drawee bank's customer should not be allowed to circumvent his estoppel against the drawee by suing a collecting bank.

Keeping in mind this inconsistency in case law, legislative reform should deal with this issue directly.

**Conclusion**

In connection with the uniformity among the Bills of Exchange Act jurisdictions, the observation has been made that "[t]he interpretation by Canadian courts of the Canadian law of bills more closely reflects the Australian courts' interpretation of the Australian law than the New York courts' interpretation of [the American Uniform] N.I.L. resembles that of the courts of Illinois." Such uniformity may be jeopardized by unilateral action aimed at extensive reformation of the Canadian Act. At the same time, as demonstrated in this paper, in some areas legislative reform is almost overdue. The right course could therefore

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260 See in general, footnotes 228-9 and text, *supra*.
262 *Supra*, footnote 257.
263 The Uniform Negotiable Instruments Law ("N.I.L.") preceded Article 3 of the UCC as the uniform statute governing bills and notes in the various American states.
264 Barak, *supra*, footnote 25 at p. 11.
be selective reform, directed at revising particular provisions only. Alternatively, a new payment code, if adopted, will supersede the Bills of Exchange Act in any event. Such a new code should take into account a revision in the areas discussed here.

Comment on Benjamin Geva's Paper: "Reflections on the Need to Revise the Bills of Exchange Act — Some Doctrinal Aspects"

Stephen A. Scott*

Sir Mackenzie Chalmers' great statute, in its Canadian form, governs the life of a note from its very creation, until its extinction on its return to its maker (Bills of Exchange Act, ss. 141, 186). Not content with that, the Act even holds out hope of resurrection (s. 73). In light of these and many other achievements, it seems to me obvious that its amendment is not by any to be enterprized, nor taken in hand, unadvisedly, lightly, or wantonly; but reverently, discreetly, advisedly, soberly, and in the fear of God.

This being acknowledged, I fully agree that the statute could use revision, though I would move much more cautiously than, I think, would Professor Geva. Certainly it could be improved in many dozens of details unlikely to involve much controversy. Falconbridge himself has pointed to a large number of useful reforms.

Professor Geva has however chosen several important branches of the law of banking and negotiable instruments as the subject of his address. As I have not had the leisure to prepare a written response doing justice even to these, I shall forego the temptation to deal with others. In doing so I am putting aside, for example, the whole question of revision of requirements of form; a subject which includes (as merely one instance) the important

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265 Among Commonwealth jurisdictions, there is no body designed to secure uniformity in law reform and revision as is the National Conference of Commissioners on Uniform State Laws in the United States. Co-ordination in revising the BEA is politically unrealistic. This is not to mention the fact that quite a few BEA jurisdictions are no longer affiliated with the Commonwealth.

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