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verify those verification clauses – an update to account agreements may be in order

Changes made by banks to their standard financial services agreements in recent years are proving to be important and necessary. A decision of the Ontario Court of Appeal, released on July 12, 2010, demonstrates potential shortcomings of older versions of account operation agreements and suggests that banks should regularly review and update their standard agreements to ensure that they afford adequate protection from risk.

background

In *SNS Industrial Products Limited v. Bank of Montreal*,[1] the plaintiff's office manager forged the signature of the plaintiff's president on several cheques over the course of three years. SNS Industrial Products Limited ("SNS") sued Bank of Montreal (the "Bank") for honouring the forged cheques drawn on its account.

SNS relied on section 48 of the *Bills of Exchange Act*[2] which provides that a forged or unauthorized signature is wholly inoperative and that no right to enforce payment on the bill can be acquired through such a signature.

In defending the action, the Bank relied on an account verification clause contained in the agreement SNS signed when it opened its account with the Bank. The clause provided in part that SNS would check the entries on its monthly account statements and notify the Bank of any "errors, irregularities or omissions" within 30 days of the statement's delivery. The clause also provided that after the 30 day period, it would be conclusively settled between SNS and the Bank that the balance shown on the statement was correct and that the cheques and vouchers referred to on the statement were properly charged.

[1] 2010 ONCA 500, aff'g 2009 CanLII 4246 (ON S.C.J.) [*SNS*].

[2] R.S.C. 1985, c. B-4 (the "Act").

trial decision

The trial judge observed that under s. 48 of the Act, the Bank was strictly liable for honouring the forged cheques. The judge was not satisfied that the operative verification clause relieved the Bank from such liability. He ruled that entries on the monthly statements in respect of forged cheques were not "errors, irregularities or omissions" that SNS was required to bring to the Bank's attention.

With respect to the meaning of an "error" or "irregularity" on the monthly statement, the trial judge held that:

> …in the context of banking nobody talks about forgery as an error or irregularity. It is a serious crime, and it is well known to have the effect of vitiating a cheque. In legal drafting, "irregularity" is associated with a minor error that does not vitiate the matter to which the irregularity refers.

The trial judge also found that the honouring of a forged cheque could not be termed an "omission".

Accordingly, the Court held that the Bank could not rely on the verification clause to escape liability under s. 48 of the Act. The Bank was held liable for honouring the forged cheques, which totalled $186,488. The Bank appealed.

decision at the Ontario Court of Appeal

The Ontario Court of Appeal agreed with the trial judge that the verification agreement did not apply, but for slightly different reasons. It followed a basic principle of contractual interpretation; that is, contracts should be interpreted to give effect to the intentions of the parties at the time of entry into the contract.

The Court of Appeal held that the meaning of "error", "irregularity" and "omission" was not apparent on the face of the verification clause, and it was difficult to conceive that both parties intended for the verification clause to extend to forged cheques honoured by the Bank. The Court of Appeal was thus satisfied that the verification clause did not apply, and dismissed the Bank's appeal.

factors contributing to the bank's liability

There were two extenuating factors that may have influenced the Courts' interpretation of the verification clause at issue.

First, in responding to a prior inquiry from SNS, the Bank had communicated to SNS that there was no time line that applied with respect to reporting forged cheques.

The Court of Appeal found that this message from the Bank could only have left SNS with the impression that the verification agreement did not apply to forged cheques. Had the Bank ensured that its response was consistent with the terms of the banking agreement and indicated to SNS that any problems with monthly statements had to be communicated to the Bank within 30 days, the Court of Appeal's decision may have been different.

Second, subsequent to honouring the forged cheques, the Bank updated its banking agreement with SNS. The updated verification clause specifically required that SNS notify the Bank of any forged endorsement immediately upon discovery and that upon expiry of the 30 day period, cheques on the statement would be conclusively settled as being authentic. The new agreement also added a paragraph excluding any liability on the part of the Bank relating to cheques with forged signatures if the signatures were forged by an SNS employee. The revised agreement, in contrast with that in force when the Bank honoured the forged cheques, clearly contemplated and addressed the facts at hand and bolstered the Courts' view that the prior verification clause did not provide the Bank with the same protections.

hold on to your verification clauses

The decisions in *SNS* should in no way be taken to mean that verification clauses are unenforceable or ineffective. While the Court of Appeal ruled that verification clauses will be strictly construed and read against a bank in cases of ambiguity, there are several indications in the reasons of both the Appellate Court and the Trial Court that current forms of verification clauses, and financial services agreements generally, may have relieved the Bank of all liability for honouring the forged cheques had such agreements been in place during the relevant time period.

In particular, the decisions suggest that account agreements that exclude a bank's liability for honouring forged cheques in instances in which the forger is an employee of the bank's customer would be an effective defence to claims under s. 48 of the Act.

The important takeaways from this case are that verification clauses, and account agreements in general, should be regularly reviewed and revised as and when appropriate, with an eye to the specific situations that they are intended to cover. In this regard, it may be effective to identify specific cases in which terms of a financial services agreement are to apply, while emphasizing that the application of such terms is to be broad and includes, but is not limited to, the specified instances. The decisions also suggest that the use of defined terms within account agreements may aid in avoiding ambiguity, which would be resolved against a bank.

In addition, banks should take care to ensure that any communications with clients are consistent with the terms of applicable banking agreements. Communications that conflict with the terms of a banking agreement may be a relevant factor in interpreting the agreement's meaning and may thus serve to vitiate the agreement's effect. It may thus be best practice for a bank's responses to client inquiries to include, when appropriate, direct reference to banking agreements in place with the customer.

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