BANK FRAUD

Practical and Legal Repercussions of Bank Fraud

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On July 12, 2004, the High Court Inspectors of Ireland presented a final report ("Report") on the affairs of the National Irish Bank ("NIB") and the National Irish Bank Financial Services Limited to the Central Bank of Ireland and the Irish Financial Services Regulatory Authority. The Report is the result of a six-year investigation into the alleged illegal practices of NIB. NIB is accused of: (i) evasion of revenue obligations through fictitious and incorrectly named bank accounts; (ii) improper charging of interest to customers; (iii) improper charging of fees to customers; and (iv) the operation of an offshore investment scheme used by some of its customers to evade taxes. The allegations of misconduct are for the period 1988 to 1998.

During the investigations, the Supreme Court of Ireland ordered that NIB executives and officials were not entitled to refuse to answer questions or supply documents to the Inspectors on the basis that the answers would be incriminating. The Court, however, did state that the admissions "would not in general be admissible at a subsequent criminal trial of such official[s] unless, in any particular case, the trial Judge was satisfied that the confession was voluntary."

The investigation confirmed the allegations against NIB and found that its senior management were responsible for the misconduct. They "had the duty to ensure that the practices did not exist and it was senior management that had the authority to put an end to them. The individual manager's authority was restricted to what happened in his or her branch. He or she cannot be held responsible for practices which existed across the branch network."[1]

As a result of the investigation, NIB has committed itself to repaying 30 million euros to the State and the Bank's customers for the misconduct. It will also pay about 34 million euros in costs for its and the Inspectors' investigations, as well as the legal costs of the Inspectors and the applicable government bodies. On September 13, 2004, NIB's parent company, the National Australia Bank, announced its intention to sell its ownership in NIB.

A survey of media reports in recent years indicates that NIB is not alone in the duping of bank customers and stockholders. The National Australia Bank is currently fighting a foreign exchange scandal which resulted in a US$360 million loss. In 2001, the ex-commercial loans officer and vice president of the National Bank of Newport (now National Bank of Tennessee) was sentenced to 37 months imprisonment and was ordered to pay about US$1.2 million in restitution. The ex-official prepared and submitted over 300 false and fraudulent loan applications in the names of fictitious persons and obtained over US$3.2 million in proceeds between 1990 to July 2000. The Tennessee Bank lost about US$1.1 million. Also in 2001, an ex-employee of Wells Fargo Bank pleaded guilty to stealing over US$1.5 million from the bank through false general ledger debit tickets.

Practical and Legal Repercussions

The results of this bank corruption are, among others, loss of goodwill, loss of customer confidence, increased marketing costs to restore the reputation of the bank and astronomical legal and investigative costs. The legal implications for the banks and banking officials are threefold: (i) criminal charges; (ii) vicarious liability for employee acts; and (iii) the implementation of government regulations and new bank policies.

Criminal Charges

In 2003, the United States Internal Revenue Service Agency, Department of Treasury reported that of 127 criminal prosecutions recommended for financial institution fraud, 108 resulted in indictments and 83 of those indictments ended in incarceration convictions. Globally, bank fraud criminal convictions of ex-employees have resulted in varied sentences from detentions at half-way houses

[1] Report at 11.

to death sentences as in China where, on September 14, 2004, four bank officials were executed for misappropriating funds of the China Construction Bank and the Bank of China. In Canada, the criminal punishment for fraud over $5,000 is a maximum penalty of ten years imprisonment. For amounts less than $5,000, fraud is punishable by up to two years imprisonment.

Offences under the *Bank Act*[2] are punishable under the Act. These offences include giving undue preferences to creditors, using the name "bank" when not permitted under the Act or making false statements in a document which purports to give security on property. Any person who is guilty of an offence under the *Bank Act* and is guilty of a summary offence can pay up to $100,000 and be imprisoned for a term of not more than twelve months. If the person is guilty of an indictable offence, he or she can pay a fine of up to $500,000 and be imprisoned for a term of not more than five years. In cases where the Bank is guilty of a summary conviction, it can pay up to $500,000 or, on conviction of an indictable offence, it can pay up to $5,000,000.

Vicarious Liability for Employees' Misconduct

Critical to the economic viability of banks are the costs associated with employee misconduct. Canadian case law indicates that banks are vicariously liable for employee's fraudulent misconduct that affects their customers. In *Royal Bank of Canada v. Nowosad*,[3] the Manitoba Queen's Bench held that the Bank could not claim repayment of a loan that only existed because of its employee's misrepresentation to the borrower. So long as the employee is acting within the purview of his employment, banks are held liable. In the Supreme Court of Canada decision of *Royal Bank v. Mack*,[4] the Court held that Royal Bank was not liable for the acts of its agent where a branch manager purporting to act on behalf of the Bank induced a customer to withdraw money and give it to him for the purpose of investing. The employee then stole the money. Although the customer believed that the employee was acting within his employment, it was held that the employee had no authority to engage in the transaction pursuant to the *Bank Act*.

Not surprisingly, there is relatively little litigation where a customer sues his or her bank where the bank's employee committed the misconduct. Like the NIB scandal, banks often settle in these situations.

However, as a result of banks' liability for employee misconduct, banks can successfully sue their employees. In *Toronto Dominion Bank v. Guest*,[5] the Bank sued its manager for acts or omissions which fell within the scope of the manager's duties of employment. The Court found the bank manager liable "for a tort other than the tort of innocent negligent mis-statement or misrepresentation ... made in pursuance of the contractual relationship between bank and customers." However, a civil suit against an employee is not practical in large fraud or intentional misrepresentation schemes where an employee does not have deep pockets.

Regulation

As a result of the ultimate bank liability and as a solution to these acts of misconduct, governments and legal communities have implemented corporate governance regulations. Banks have discretion to carry out their tasks. They advocate self-regulation and the building of renewed trust for its corporate executives. However, public comfort with banks lies with government intervention and regulation. Generally, these regulations are sufficient to punish those who commit fraud, but do not address preventing the misconduct. An exception to this is the external anti-fraud measures taken by the United States Congress through the enactment of *The Prevent Bank Fraud by Terrorist Act 2003*. Bank fraud of non-employees or banking officials has been linked to the funding of terrorist activities in the United States. As a result, Congress implemented this Act which necessitates that banks report the taxpayer identification number to the appropriate government agency (i.e., IRS) when new bank accounts are open. Despite this measure, the task of preventing bank fraud remains in the hands of the banks.

[2] *An Act respecting banks and banking*, S.C. 1991, c. 46, as amended [hereinafter *Bank Act*].
[3] (1972), 31 D.L.R. (3d) 103 (Man. Q.B.).
[4] [1932] 1 D.L.R. 753 (S.C.C.).
[5] [1979] B.C.J. No. 1311 (B.C.S.C.).

The most effective method to prevent employee bank fraud is the implementation of internal controls. The segregation of duties, internal audits, outsourcing and the implementation of policies and procedures are each mechanisms used to combat fraud. Section 157 of the *Bank Act* stipulates that banks must establish, among other things, the following:

- an audit committee;
- a conduct review committee;
- procedures to resolve conflicts of interest;
- procedures to provide disclosure of information to customers of the bank; and
- investment and lending policies, standards and procedures.

A bank may also appoint other committees and delegate powers of the bank's directors, and assign to those committees duties as the directors deem appropriate.[6] Segregation of duties through the use of this process helps prevent situations of conflict and temptation.

In May 2001, the Office of the Superintendent of Financial Institutions Canada published a Guideline on Outsourcing Business Functions for federally regulated financial institutions which sets out the federal government's expectations on outsourcing. The Guideline requires the banks to establish a risk management program to evaluate the risk and materiality of all existing and proposed outsourcing arrangements and to monitor and control risks arising from material outsourcing arrangements. The Guideline outlines the criteria to qualify for materiality. A bank is also required to, among other things: (i) provide to the federal government a detailed breakdown of all revenues and expenses that accrue to it; (ii) maintain records to allow the government access to the information; and (iii) isolate the bank's process from the outsourcing process, if the entities share facilities.

Despite all these precautions, fraud can occur even though banks have created strong internal controls. The underlying matter is the character of the employee and the opportunity given to that employee. People who lack moral character are disposed to committing these acts. That said, banks cannot realistically expect to know or predict its employees' behaviour. The Federal Bank Reserve of Philadelphia has suggested the following strategies to prevent internal fraud:

- requiring employees to avoid and disclose conflicts of interest;
- requiring employees to follow a code of ethics;
- requiring employees to maintain good credit ratings;
- requiring adherence to policies for rotation of duties and mandatory vacations;
- requiring the use of employee identifications cards for access to secure areas;
- restricting access to controlled areas; and
- developing and implementing computer security techniques.

Conclusion

The NIB scandal is just one of numerous examples of bank fraud that has plagued the financial industry worldwide. It represents the height of bad management and employee deception and has regulators and the public screaming with discontent. Government regulations aid in preventing these white collar crimes but it is the internal banking policies and the character of the employees that is the real issue. Screening employees and developing excellent employer-employee relationships are ways to thwart misconduct. However, in the end, it is deterrence by punishment that resonates with employees and it is banks who are left to rebuild the lost customer trust.

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[6] Section 193 of the *Bank Act.*