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Responsibility of Financial Institutions as Potential Intermediaries of Fraud and the Cheapest Cost Avoider Principle

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ABSTRACT

Generally, a bank may owe a duty of care towards its customers in a negligence claim. In a recent case of *Koperasi Sahabat Amanah Ikhtiar Bhd v RHB Investment Bank Bhd*, the Court of Appeal extended the duty of care of banks to non-customers. This new ruling has a significant impact on the bank to ensure that the bank will exercise reasonable skill and care in performing its duties to both customers and non-customers. The fact that a contractual relationship does not exist is not a bar to establish a duty of care in negligence claims. The principle of cheapest cost avoider is consistent with the doctrinal approach taken by the Court of Appeal in affirming the duty of care of financial institutions since financial institutions are most likely in the best position to deter fraud and minimise losses due to such over-sight. It is also suggested that such duty should also be applied to other deposit-taking financial institutions such as electronic wallet providers against unauthorised transfer for funds from account holders.

Keywords: Duty of care; Financial institutions; Non-customers; Cheapest cost avoiders; Malaysia

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1. Introduction

Financial institutions such as banks play an essential role as the gatekeepers of monetary assets in an economy. On a daily basis, funds are deposited into customers' accounts and transferred to others in either the same financial institution or to another. To ensure that all transactions end up where they are supposed to be, financial institutions have put in place and practice strict operating procedures to ensure that as few mistakes are made as possible. Some of these include procedures to prevent fraudulent transactions being made through the banking system.

In a recent decision in *Koperasi Sahabat Amanah Ikhtiar Bhd v RHB Investment Bank Bhd*,[1] the Malaysian Court of Appeal had the opportunity of examining the question of a bank's duty of care to a non-customer under negligence law. This case involves a fraud committed by a person upon the plaintiff co-operative, whereby the defendant bank, through one of its employees, facilitated the completion of the fraud.

In this article, we discuss the logic of the *Koperasi Sahabat* case, and how this case is vital for imposing an intermediary responsibility and liability on financial institutions in the fight against online fraud on customers' accounts. Apart from performing a compensatory function, tort law also acts as a deterrence on potential tortfeasors.[2] This is particularly important when the actual tortfeasors are difficult to detect and take action against because they are anonymous and outside the jurisdiction of Malaysia. Therefore, intermediaries such as financial institutions acting as gatekeepers of financial transactions may play a crucial role in preventing fraudulent transactions from being completed.

Finally, we use the cheapest cost avoider principle, as introduced by Guido Calabresi,[3] to give an economic justification for imposing intermediary liability on financial institutions against online bank account fraud.

2. *Koperasi Sahabat Amanah Ikhtiar Bhd v RHB Investment Bank Bhd*

The *Koperasi Sahabat* case is legally significant as it establishes the principle that banks and financial institutions owe a duty of care to non-customers when dealing with money deposited with the former. Or more broadly speaking, the same decision can be interpreted to mean that a bank or financial institution may have a duty of care against anyone whose

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1 *Koperasi Sahabat Amanah Ikhtiar Bhd v RHB Investment Bank Bhd* [2023] 1 Current Law Journal 495 (CA).

2 Oliver Wendell Holmes Jr, *The Common Law* (Little, Brown, and Company 1881) 144; John CP Goldberg, 'Twentieth-Century Tort Theory' (2003) 91(3) Georgetown Law Journal 513 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=347340>.

3 Guido Calabresi, 'Does the Fault System Optimally Control Primary Accident Costs Safety' (1968) 33 Law and Contemporary Problems 429 <https://openyls.law.yale.edu/bitstream/handle/20.500.13051/1265/Does_the_Fault_System_Optimally_Control_Primary_Accident_Costs.pdf>; Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (Yale University Press 1970).

money passes through their system to ensure that sufficient safeguard measures are implemented so that they do not become an accessory or instrument of fraud.

2.1 Facts of the Case

The plaintiff-appellant in the *Koperasi Sahabat* case is a co-operative established under the Co-operative Societies Act 1993. The appellant was misrepresented by the second respondent who purportedly represented himself as the agent of the first respondent, RHB Investment Bank, to invest RM10 million for a three-year investment scheme. The appellant issued a cheque for RM10 million payable to the first respondent. The second respondent afterwards issued a forged letter containing details of the category, profile, distribution policy, dividend yields and other information about the purported investment which turned out to be fake.

Upon the instruction of the second respondent, the RM10 million was transferred to the third respondent's account, Abhar Capital Holdings Sdn Bhd with the assistance of the first respondent's employee and their Credit Control department. The third respondent had a trading account with the first respondent so a bank-in slip from the second respondent was accepted, although the name of the appellant on the RM10 million cheque was different from the name of the third respondent. The transfer to the third respondent's account was made without the appellant's authority. Upon investigation, it was found that the directors of the third respondent were the second respondent's sons.

The appellant only realised they were defrauded when the Co-operative Commission and the Securities Commission notified them. The appellant sued the first, second and third respondent. Judgement in default was entered against the second and third respondents as they had gone bankrupt and into liquidation, respectively. The action at the High Court against the first respondent bank was unsuccessful on the ground that the appellant was not a bank customer. Hence, the appellant appealed against the first respondent at the Court of Appeal.

2.2 Decision of the Court of Appeal

On appeal, the court further examined whether the first respondent owes a duty of care towards the appellant whose money was transferred without the appellant's authorisation despite not being its customer. After assessing the claims, the Court of Appeal overturned the High Court's decision on several grounds.

Firstly, the Court of Appeal Judge, Justice Lee Swee Seng believed that the absence of a contractual relationship is not a bar in establishing a duty of care in negligence law. The celebrated case of *Donoghue v Stevenson* established that a manufacturer of ginger beer owes a duty of care to a non-purchasing consumer in negligence despite not having a contractual relationship.[4] In the instance case, the Court of Appeal affirmed that a duty of care may be

[4] *M'Alister (or Donoghue) v Stevenson* [1932] Appeal Cases 562 (HL).

determined by way of proximity, foreseeability and policy consideration, as discussed in the case of *Caparo Industries plc v Dickman*.[5] Following the Federal Court in *Pushpaleela a/p R Selvarajah v Rajamani d/o Meyappa Chettiar*,[6] which recognised *Caparo Industries's* three-fold test, the applied *Pushpaleela* as a test for duty of care.

According to Court of Appeal, upon receiving the RM10 million, the first question that should be determined by the first respondent is the identity of the depositor and whether the depositor had an account with the first respondent. These questions are crucial since the money that was deposited into the pool account was within the control of the first respondent. The first respondent should also consider whether it has the proper mandate from the depositor to transfer the RM10 million to a third-party account. It was not difficult for the first respondent to find out the details of the depositor as the name of the account holder was stated on the cheque. Lastly, whether the first respondent could foresee that if it acts based on the instruction of an unauthorised person, the appellant has the possibility of losing his money? The answer seems clear. It is foreseeable that without proper inquiry, the appellant may lose his money.

A person or company may be liable to a non-client in a professional field. Although the first respondent argued that in the case of *Pushpaleela* a person owes no duty of care towards a non-client, the lawyers in that case had done their part to verify the vendor's identity. Instead, in the present case, the depositor's identity was not verified. The Court of Appeal also found that to hold that a lawyer or a professional can never owe a duty of care towards a non-client seems too rigid.

After establishing that the bank or the first respondent owes a duty of care, it must also be established whether the bank has breached its duty. The standard of care used in determining a breach of duty is whether a reasonable prudent banker would act justly given the same circumstances. A bank has a duty to prevent fraud and safeguard the interest of its customers and other innocent third parties. The bank must refrain from executing transactions if the matter is 'put on inquiry'.[7] In the current case, the court refuse to accept the first respondent's argument that it was difficult to verify the transactions and there were simply too many depositors to be verified per day. Despite the large number of transactions, the bank should act reasonably by verifying the depositor's identity in any transactions. The bank, therefore, is in breach of duty the moment it acts without the mandate of the customer or depositor.

The fact that the bank allowed itself to be an instrument to facilitate fraud is another factor to be taken into account in determining the breach of duty. The act of the first respondent transferring the money based on a phone call and unsigned bank-in slip, followed by failing to verify the identity of the cheque's depositor, is enough to establish that the first respondent's employee's actions are dangerous and could be used to facilitate

[5] *Caparo Industries plc v Dickman* [1990] 2 Appeal Cases 605 (HL).

[6] *Pushpaleela a/p R Selvarajah v Rajamani d/o Meyappa Chettiar* [2019] 2 Malayan Law Journal 553 (FC).

[7] *Public Bank Bhd & Anor v Exporaya Sdn Bhd* [2013] 1 Malayan Law Journal 507 (CA).

fraudulent acts. The Court of Appeal held that to deny legal responsibility means that banks can be used as an instrument of fraud.

In determining proximity and foreseeability of harm, the court referred to the case of *Semac Industries Ltd v 1131426 Ontario Ltd.*[8] This case affirmed that banks 'should owe a duty to those who are asked by their customers to deal with them to not knowingly permit their facilities to be used for fraudulent purposes.' A bank would be in breach of its duty whenever it is aware or has reasonable grounds that fraud is used in its facilities but failed to make reasonable inquiries.

The Court of Appeal also pointed out that the first respondent's employees had failed to comply with its own standard operating procedure. The fact that the first respondent's officer and Credit Control Department failed to verify whether the source of funds belonged to the third respondent or otherwise proved that there was a non-compliance in their standard operating procedure. It was also upheld that the first respondent is negligent by using the 'but for' test as stated below:

> We agree with learned counsel for the plaintiff that but for D1's breach, the RM10 million would not have been channelled to D3's trading account which then enabled D3 to siphon off the monies shortly thereafter.

2.4 Significant Principles

The appeal judge has put together a detailed and insightful analysis to cover the issues in his judgment. From this judgment, he has firmly extended banks' duty of care to non-customers. Although this may cause panic in the banking institution, it is necessary to protect innocent third parties, as what had transpired in this case. Financial institutions are placed with a duty to manage funds that are transferred to them. Furthermore, the whole *raison d'être* of the principle in negligence cases such as *Donoghue v Stevenson* and *Caparo Industries* is to impose a duty of care outside of a contractual relationship. Hence, so long as *Caparo Industries'* three-fold test is established, the duty of care may arise. Thus, the argument that there is no duty of care due to the absence of a contractual relationship must not stand.

Another significant observation made by the court was that banks should not be used as an instrument to facilitate fraud. Banks should thoroughly check each transaction received despite having many transactions every day. By checking the transactions in detail, customers and non-customers may be protected from fraudulent transactions. The bank thus has a duty to verify with the relevant parties before transferring the funds to a third party.

[8] *Semac Industries Ltd v 1131426 Ontario Ltd* [2001] Ontario Judgments No 3443 (SCJ).

3. The Cheapest Cost Avoider Principle

The economic principle of cheapest cost avoider can explain why financial institutions should have a legal responsibility to minimise fraud in banking transactions. Guido Calabresi introduced the concept of 'cheapest cost avoider' and proposed three criteria in choosing the cheapest cost avoider: (i) 'the optimal relationship between avoidance costs and administrative costs must be sought,' (ii) 'the maximum degree of internalization of costs consistent with the first criterion should be sought,' and (iii) 'allocate accident costs in such a way as to maximize chances that errors in allocation are corrected in the market.'[9] In simple terms, the cheapest cost avoider principle normatively asks the law to impose a legal responsibility on a party who is in the best position to lower the costs from mistakes or accidents while making sure that the administrative cost is not unduly prohibitive.

The theory goes that if such legal responsibility is imposed on the cheapest cost avoider, the party will take the necessary precaution to minimise his cost for his own personal benefit, while at the same time, the cost of mistakes will also be minimised. In other words, the cheapest cost avoider principle is just a way to align personal self-interest of the party having a duty to the social interest of minimising mistakes.

In the case of *Koperasi Sahabat,* the only party involved in processing the cheque is the first respondent bank. By bearing some administrative cost to ensure that the issuer of the cheque corresponds to the recipient-holder of an investment account, the bank would be able to minimise mistakes and fraud arising from transferring funds to the wrong party. It should also be noted that it might be the case that investment banks frequently have agents outside their bank premises seeing investments from interested parties, and cheques for such investments are issued and handed over to the agents. The fact that such cheques are issued in the name of the investment bank is the only safeguard in such a system to ensure fraud by a fraudulent agent. The alternative safety procedure of requiring investors to present themselves in the bank's premises to make such bank-in may not benefit the investment-seeking banks as it would potentially reduce the number and amount of such investments.

3.1 Responsibility of Financial Institutions as Intermediaries

Often intermediaries, especially online intermediaries, are the cheapest cost avoider against illegal or tortious transactions.[10] This is because intermediaries often act as bottlenecks where transactions of the same kind have to go through the system, and hence a verification system may be put in place to verify each transaction before it can proceed to the next phase. This is an economic saving on administrative costs compared to the alternative of a larger number of dispersed parties having the responsibility to minimise the cost of illegal or tortious transactions.

[9] Calabresi, 'Does the Fault System Optimally Control Primary Accident Costs Safety' (n 3).

[10] Jack M Balkin, 'Room for Maneuver: Julie Cohen's Theory of Freedom in the Information State' (2012) 6 Jerusalem Review of Legal Studies 79, 92 <https://core.ac.uk/download/pdf/72834888.pdf>.

In relation to electronic banking system, it was observed that the bank 'presumably is in a better position than its customer to know how best to effect payment and to control all aspects of a wire transfer. As the bank is the cheapest cost avoider, it has to takethe corrective measures in case of erroneous or delayed transfer.'[11]

Indeed, the national bank of Malaysia, Bank Negara, requires financial institutions to monitor and report against potentially illegal money transfers under the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001.[12] The fact that financial institutions are imposed this legal responsibility is because they are the bottlenecks and intermediaries of the financial world, and thus make good cheapest cost avoiders, the cost being the social costs of illegal activities.

3.2. Financial Institutions' Responsibility against Online Account Fraud

Taking an expensive view of the *Koperasi Sahabat* case, it is suggested that financial institutions, such as banks, and also electronic wallet providers, should have a duty of care against reasonably detectable fraudulent transactions when funds travel through their systems, regardless of whether the victims of fraud are customers or otherwise. Indeed, based on the *Koperasi Sahabat* decision, if a non-customer is owed a duty of care, it makes no sense to exclude the same duty of care to customers having a contractual relationship, solely on the ground of liability exclusion clauses. It is possible that such liability exclusion clauses may be found to be unenforceable under unfair contract terms under the Consumer Protection Act 2019.

In recent years, online bank account fraud cases have increased. In such cases, the victims complain that funds from their online bank accounts have been transferred to a third party, usually a mule account, before being further transferred or withdrawn by the fraudsters. Causes of such fraud may be due to social-engineering against the victims, spear-phishing,[13] Trojan Horse,[14] and possibly, hacking against financial institutions' systems.

There are numerous ways to protect customers against online banking fraud, starting with protecting the online environment itself. For instance, customers using unsecured Internet connections could be susceptible to online fraud.[15] Hence, it is advisable for

[11] MX Thunis, 'Questions of Liability in Value Added Network Services: The Case of Electronic Funds Transfers' in S Schaff (ed), *Legal and Economic Aspects of Telecommunications* (Elsevier Science Publishers BV 1990) 698.

[12] Bank Negara Malaysia, 'Anti-Money Laundering, Countering Financing of Terrorism and Targeted Financial Sanctions for Financial Institutions' (2019) <https://www.bnm.gov.my/documents/20124/938039/AMLCFT+PD.pdf>.

[13] Gerald Goh Guan Gan and others, 'Phishing: A Growing Challenge for Internet Banking Providers in Malaysia' (2008) 5 Communications of the IBIMA 133 <https://ibimapublishing.com/articles/CIBIMA/2008/252213/252213.pdf>.

[14] Gita Radhakrishna, 'Liability Issues in Internet Banking in Malaysia' (2009) 7 Communications of the IBIMA 1 <https://ibimapublishing.com/articles/CIBIMA/2009/639132/639132.pdf>.

[15] Chris MacDonnell, 'Five Ways to Protect Against Bank Account Fraud' *New Hampshire Business Review* (3–16 April 2015) 26 <https://www.nhbr.com/five-ways-to-protect-against-bank-account-fraud/>.

customers to use trusted Internet source. Employers should also ensure that their employees are educated on possible banking scams and verify that the employees abide by the company's safe practices and take note of warning signs.[16] In case of a suspected scam transaction, the customer or employee should directly contact the bank and confirm the status of the transaction.[17] Device authentication is also a good way to prevent unauthorised transactions. On another note, customers need to be wary of links that is provided in an email or forwarded in a form of text messages[18] By clicking on the link, customers may be scammed by a 'phishing' technique.

In conclusion, having a duty of care for financial account-holders, makes may financial institutions responsible and answerable to minimising online fraud incidences. Financial institutions may, through their bottleneck positions, put in place mechanisms to detect and deter fraudulent transactions.

4. Conclusion

The judgment by the Court of Appeal in *Koperasi Sahabat* imposed an extended duty of care of the bank towards non-customers. The bank cannot escape from its obligations towards non-customers simply by arguing that no duty of care is owed due to the absence of a contractual relationship. It seems that the bank must equip itself with extra measures so that both customers and innocent third parties are protected from fraudulent activities. Having many transactions per day is not a basis for not verifying the transactions. By verifying the transactions, the bank may be able to protect the parties of the transaction from fraudulent acts.

The principle of cheapest cost avoider is consistent with the doctrinal approach taken by the Court of Appeal in affirming the duty of care of financial institutions since financial institutions are most likely in the best position to deter fraud and minimise losses due to such over-sight. It is also suggested that such duty should also be applied to other deposit-taking financial institutions such as electronic wallet providers against unauthorised transfer for funds from account holders.

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[16] MacDonnell (n 15).

[17] MacDonnell (n 15).

[18] Alix Kaufmann, 'Combat Scammers: How to Prevent Fraud for Business Accounts' *Smart Business* (June 2022) 50 <https://sbnonline.com/article/how-to-prevent-fraud-for-business-accounts/>.