BETWEEN: ROYAL BANK OF CANADA Applicant and WILLIAM D. DARLINGTON, WILLIAM T. GAUKRODGER, G. GORDON SYMONS and IAN C. MUNRO Respondents - and - BETWEEN: ROYAL BANK OF CANADA Applicant and PETER J. CLARKE and MURRAY O'NEIL Respondents - and - BETWEEN: HONGKONG BANK OF CANADA Applicant and JANE A. PERRIN, WILLIAM E. PERRIN, HUGH S. HENDRIE, MAJORIE I. HENDRIE, SEAN P. McDONOUGH, EDWARD R. REYNOLDS and HONGKONG and SHANGHAI BANKING CORPORATION LIMITED Respondents - and - BETWEEN: CITIBANK CANADA Applicant and JACQUELINE LEVIN Respondent

Royal Bank of Canada v. Darlington

File No. B312/93; B311/93; B73/94; B128/94

Ontario Court (General Division)

1995 A.C.W.S.J. LEXIS 47852; 1995 A.C.W.S.J. 633197; **54 A.C.W.S. (3d) 738**

April 19, 1995, Decided

KEYWORDS:

[*1]
FINANCIAL INSTITUTIONS -- Letters of credit -- Obligation of institution to honour letter of credit – Exemption in case of fraud -- Investors in underwriting syndicates into Lloyd's Insurance provided letters of credit for potential liability on calls -- Investors failed to show alleged fraud by Lloyd's -- Investors were liable to banks which paid on letters -- Clear and obvious fraud was not shown -- Banks had no duty of outside inquiry.

SUMMARY: Investors in underwriting syndicates, operating in relation toLloyd's Insurance of London, England, were required to provide letters of credit or letters of guarantee before being accepted as underwriting names -- Each respondent had provided letter of credit which was for use in event of call by Lloyd's -- During 1980s, several financial scandals and serious problems affected stability of funding of Lloyd's, with resultant risk to underwriters -- Major potential liability arose in respect of potential claims worldwide, based on asbestos injuries, and extent of liability was unknown -- Acts of syndicates operating in London in manner of closing off accounts in specific years with insufficient reinsurance in effect to cover potential liabilities, [*2] resulted in increased risks for non-English syndicates, including respondents -- On calls against letters held by Lloyd's against respondents, banks were instructed not to pay, on basis of fraud by Lloyd's -- Banks were provided with materials relating to alleged fraudulent matters involving Lloyd's, including asbestos issues, highly risky reinsurance spiral practice, dubious use of time and distance policies, and scandals relating to named syndicates, including acceptance of new underfunded syndicate, headed by person involved in previous scandal -- Banks reviewed materials, took legal advice, and decided to pay on letters, although other banks had formed opinion of fraud and declined to pay -- Banks claimed from investors --

HELD: Banks had obligation to pay unless fraud exception applied -- Fraud for operation of exception must be clear and obvious -- This was test, rather than any consideration of appearance of fraud to reasonable banker -- Banks had no duty to make outside inquiry -- Some of materials supplied to banks comprised investigatory materials, which outlined issues in detail, but banks were not supplied with portions in which it was concluded that fraud was absent [*3] -- Respondent investors could not rely on materials without reference to conclusions -- Banks had no duty to advise sophisticated investors as to nature and effect of letters of credit -- Fraud was not clear and obvious, and banks properly paid on letters -- Investors were liable to banks. A.C.W.S.

COUNSEL: Brian Casey and
Ms. Janet Kirby, for Applicants Citibank Canada and Hong Kong Bank of Canada
George Glezos and
Susan Wortman, for Applicant Royal Bank of Canada
Alan J. Lenczner. Q.C. and
Glenn A. Smith, for the personal Respondents in all proceedings

JUDGES: R.A. Blair J.

R. A. Blair J. :
PART I
OVERVIEW, ISSUES AND PRELIMINARY MATTERS
OVERVIEW

[**1] The 18 individual Respondents in these proceedings are underwriting members of Lloyd's of London. In the parlance of the insurance industry, they are known as "Lloyd's Names". Lloyd's Names participate in the insurance underwriting process as members of syndicates.

[**2] In their capacity as Names the Respondents were each required to lodge with the **Society of Lloyd's** a letter of credit to secure the deposit obligations which underly their ability to underwrite insurance. They did so. As a result of very serious losses experienced by the [*4] syndicates in which the Respondents participated, the Society has made calls upon the letters of credit, which were issued in its favour by the Applicant Banks at the request of the Respondents.

[**3] These calls have been resisted by the Names. They claim that they have been the victims of fraud on the part of Lloyd's. They assert that they have tendered to the Banks evidence of "clear or obvious fraud" on the part of Lloyd's, sufficient to relieve the Banks of their obligation to honour the letters of credit, in accordance with principles laid down in Bank of Nova Scotia v. Angelica-Whitewear Ltd. et al. [1987] 1 S.C.R. 59. In that case, the Supreme Court of Canada ruled that the test to be applied by a Bank facing such allegations and required to make its own decision without a restraining court order is,

whether fraud [is] so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank (per LeDain J., at p.84).

[**4] The Banks who are Applicants in these proceedings were not persuaded that clear or obvious fraud on the part of the Society and Council of Lloyd's had been established [*5] on the documentation and materials provided to them. They honoured the Letters of Credit, and paid. They now seek reimbursement from the Names.

[**5] The obligation to reimburse the Banks, if found, and the attendant unlimited liability which attaches to being a Lloyd's "Name", will create considerable hardship for the Respondents. There is little doubt on the evidence that these calls, and the liabilities which have been incurred as a result of the inordinate losses sustained in the Lloyd's market in recent years have wreaked havoc on the lives and fortunes of these Names, and others who find themselves in similar positions. Many are in danger of losing their homes or, worse, are on the verge of bankruptcy.

[**6] Adding to the frustration of the Names is the fact that, while the three Applicant Banks decided there was insufficient evidence of fraud, and paid Lloyd's, five other Canadian Banks with customers in apparently similar positions, and on the same materials, decided that the evidence was sufficient, and refused to pay!

[**7] For their part, however, the Applicant Banks argue they acted honestly and reasonably in coming to their respective decisions that clear or [*6] obvious fraud had not been established, and, accordingly that they were contractually and legally obliged to honour the draws on the Letters of Credit in question. They seek declaratory relief to this effect, and reimbursement from the Respondent Names for the amounts paid.

THE ISSUES

[**8] The issues raised at trial centred around the "fraud" defence and the question of whether, even if fraud were not established, the Banks were disentitled to reimbursement because of alleged failures to advise their customers adequately and because of a failure to follow their customers' instructions faithfully.

(i) The "Fraud" Defence

[**9] The "fraud" defence was the main focus of the Respondents' attack upon the decisions of the Applicant Banks to honour their letters of credit. In this context, the defence raises a number of issues which do not so much concern the question of what is the test to be applied in such circumstances – that issue has been settled by the Supreme Court in Angelica Whitewear -- but which are more concerned with the question of how the test is to be applied. These issues, which may be described as pertaining to the practical "banker's test", may be summarized [*7] as follows:

[**10] (1)What is the duty cast upon a banker presented with materials and information which the customer asserts establish clear or obvious fraud on the part of the beneficiary of the letter of credit ?

[**11] (2)Is the performance of that duty to be measured objectively, that is, by the test of what "a reasonable banker" would have done; or is the measuring stick a more subjective one, namely that of a banker acting honestly and in good faith in the exercise of his or her function as a banker?

[**12] (3)What is the level of satisfaction required on the part of the banker, i.e., what is the burden of persuasion cast upon the customer seeking to resist the call ?

[**13] (4)Is there an obligation on the part of the bank to make further inquiries beyond the materials and information presented to it ?

[**14] (5)Finally, what is the obligation of a Court when asked to determine whether the bank was justified in honouring -- or failing to honour -- the letter of credit ?

(ii) The Reimbursement, or indemnification, Issue

[**15] While the "fraud" defence was the primary focus of attention at trial, there are several additional issues raised in the proceedings. [*8] They concern the Banks' claims to be indemnified by the Respondents. The Respondents argue that even if the fraud defence fails, the Banks are disentitled to reimbursement from them because,

[**16] a)they failed to meet a duty to advise their Respondent customers of the risk of the letters of credit being called at will and without any proof of loss on the part of Lloyd's;

[**17] b)they failed, in certain circumstances, to comply strictly with the instructions of their clients, on whose behalf the letters of credit were issued (this argument is duplicated as the defence of "failed documentary compliance" in connection with the calls of the letters of credit themselves);

[**18] c)in certain instances the Indemnity Agreements between the Bank and the customer stipulated for indemnification pursuant to a letter of guarantee , whereas what had been issued was a letter of credit ; and because,

[**19] d)in the case of the Hongkong Bank of Canada letters of credit, there had been an unauthorized change in conditions when the letters of credit were transferred from Lloyd's Bank Canada to the Hongkong Bank of Canada.

PRELIMINARY MATTERS

[**20] Before proceeding to examine [*9] the facts and the law in the context of these issues, I pause to make note of several matters of a preliminary nature.

[**21] These proceedings were originally commenced as six separate Applications, two on the part of Hongkong Bank of Canada, three on the part of the Royal Bank of Canada, and one at the instance of Citibank. AS part of the Commercial List case management process, the Applications were directed to be heard together. At the outset of the Hearing, on June 27, 1994, I directed that there be a trial of the issues raised in the Applications. That trial commenced September 19, 1994 and concluded on October 7th.

[**22] The Respondents and the particulars of their Letters of Credit which are the subject matter of these proceedings are listed on the chart which is attached as Schedule "A" to these Reasons.

[**23] In terms of the applicable law, counsel agree that while English law respecting the obligations to pay under a letter of credit is the governing law in respect of the Letters of Credit in question, that law, for the purposes of these proceedings, is as set out by the Supreme Court of Canada in Angelica-Whitewear , supra . With respect to the obligations [*10] of the Respondents to reimburse the Banks, it is Canadian law which governs.

[**24] By agreement as well, evidence has been tendered in these proceedings both by way of affidavits and exhibits thereto, and by way of viva voce evidence. The Application Records are all before the Court. Counsel assent to my having regard to these affidavits and documents, and, indeed at least with respect to those emanating from the Respondents most of them formed a part of the presentations made to the Banks by or on behalf of the Respondents as part of their attempts to persuade the Banks not to honour the letters of credit. Exhibit Books I through XII fall into this latter category.

[**25] Exhibit 18 is an Exhibit Book containing affidavits or witness statements from all Respondents, with the exception of Edward Reynolds, Peter Clarke and G. Gordon Symons. I am advised that Mr. Reynolds is bankrupt; accordingly, the proceedings are stayed as against him. A number of Respondents testified at trial, as well as filing an affidavit or witness statement. In such circumstances, it is their testimony at trial which is to govern.

PART II

THE FRAUD DEFENCE

A. A SUMMARY OF THE DEFENCES PUT FORWARD [*11]

[**26] The complaints advanced by the Respondents, and relied upon as establishing "clear or obvious fraud", fall into a number of distinct categories. Considerable emphasis, as well, is placed upon the background of what had happened in the Lloyd's market during the 1970's and 1980's as the context in which these complaints were required to be viewed. There had been a series of scandals, a number of Enquiries designed to root out the causes of these scandals, and the ultimate enactment of the new Lloyd's Act , 1982 in an attempt to reverse the deteriorating reputation of Lloyd's resulting from the scandals, amongst other things.

[**27] The several categories of complaint with respect to which the Respondents submit that "fraud" on the part of the Society and Council of Lloyd's has been established are the following:

[**28] 1) Concealment of the Extent of Pending Asbestos Claims

[**29] There are two aspects of this complaint, namely,

[**30] a) that Lloyd's knew about, and concealed the extent and unquantifiable nature of past asbestos claims, which the Names, unknowingly, assumed when they became members of Lloyd's; and,

[**31] b) that Lloyd's represented reserves [*12] taken for risk incurred prior to the Names becoming members were adequate, when it knew that insufficient and inadequate reserves had been set aside for past asbestos liabilities.

[**32] 2) Misuse of a type of insurance policy or financial instrument known as a "Time and Distance Policy"

[**33] 3) The "LMX Spiral", a particular form of catastrophe re- insurance developed in the London market which had the effect of concentrating rather than spreading risks in such circumstances

[**34] 4) Feltrim Syndicates 540/542 and 847

[**35] The allegations pertaining to these Syndicates were these:

[**36] a) that Lloyd's ought not to have approved and permitted the registration of Mr. Patrick Feltrim Fagan to manage the Syndicates, in light of his prior connection with the PCW Syndicate which had been the subject of one of the earlier scandals (although Mr. Fagan, himself, had had no involvement in it);

[**37] b) that Lloyd's secretly caused the removal of approximately 24 million from the reserves of Feltrim Syndicates 540/542 in the Fall of 1986 for the purposes of making a PCW scandal-related settlement with members regarding the 1983 year of account, and failed to disclose [*13] this removal to potential Names who were joining in later years;

[**38] c) that the removal of the 24 million left Feltrim 540/542 with a reserves to premium ratio which did not meet Lloyd's own by-law requirements;

[**39] d) that Lloyd's permitted the Feltrim Syndicates to misdescribe themselves as excess of loss re-insurers. whereas they were in reality writing the much riskier catastrophe, or LMX re-insurance; and,

[**40] e) that Lloyd's permitted the Feltrim Syndicates, along with the Gooda Walker Syndicates, to become involved in the LMX spiral.

[**41] 5) Overwriting of Premiums

[**42] 6) Misuse of Combined Re-insurance, and

[**43] 7) Misuse Of Trust Funds

[**44] I shall return to a more detailed description of these matters as these Reasons develop.

B. BACKGROUND AND FACTS

What is "Lloyd's"?)

[**45] Lloyd's of London is a venerable institution, one whose name is virtually synonymous with the word "insurance" throughout the world. Tracing its origins -- at least by legend -- to a London coffee house owned by Edward Lloyd in the late 1700's, it describes itself as "an insurance market unique in the world". Indeed, Ian Hay Davison, its former Deputy [*14] Chairman and Chief Executive officer and author of a critical book entitled Lloyd's: A View of the Room - Change and Disclosure , describes Lloyd's in these terms (at p. 11):

By any standards Lloyd's of London is a remarkable place. It is a large and flourishing survivor of Britain's mercantile and imperial past, in many ways a strange relic, but nonetheless a valuable one.

[**46] The concept of Lloyd's is a complex one, however, as is its structure. Just what is meant by "Lloyds's" is not clear. in fact, it is a conundrum.

[**47] Contrary to popular perception -- so it is said, at least -- Lloyd's does not conduct the business of insurance. It is not a company. It has no shareholders and accepts no corporate liability for risks insured in the Lloyd's market. It is instead "a society of underwriters", all of whom accept insurance risks for their personal profit or loss and are liable to the full extent of their private wealth to meet their insurance commitments.

[**48] At the same time, Lloyd's is "the marketplace" where that business is carried on. The Corporation of Lloyd's, which was first created by Act of Parliament in 1871, owns the marketplace -- which is known [*15] as "the Room" -- and provides facilities for the transaction of insurance business.

[**49] Finally, Lloyd's is "the regulator" of that marketplace.

[**50] Society of underwriters, marketplace, owner of the marketplace, and regulator of the marketplace -- "Lloyd's" in a generic sense is all of these things. There is a "**Society" of Lloyd's** -- the body incorporated by the Lloyd's Act , 1871 and continued by the Lloyd's Act , 1982. There is a "Council" of Lloyd's -- the body established by the latter Act for the management and superintendence of the affairs of the **Society of Lloyds,** and given the power to regulate and direct the business of insurance in the Lloyd's market. There is "the Committee of Lloyd's", which is made up of the 16 working, or inside, members of the Council, and to which the Council has delegated the day- to-day administration of the market.

[**51] In addition, there are four groups of people who work within the Lloyd's marketplace that is owned by the Corporation of Lloyds and regulated by the Council of Lloyds. They are the Lloyd's "brokers" (who bring in the insurance business and define the risks); the Lloyd's "underwriting agents" (who accept those [*16] risks, settle claims, and reinsure their book of risks); the Lloyd's "managing agents" (who represent and manage the affairs of the underwriting members); and finally, of course, there are the Lloyd's members or "names" themselves (who underwrite the risks).

[**52] The actual business of underwriting insurance in the Lloyd's market is carried out through "syndicates". A syndicate is a group of underwriting members or "names" which underwrites insurance as if it were a single economic entity. It is not a company, nor is a syndicate even a legal entity. Each member of a syndicate has several liability and a direct relationship to the syndicate's managing agent.

[**53] None of the brokers, the underwriting agents or the managing agents is an agent of the Society or Corporation of Lloyds. Nonetheless, while Lloyd's is said not to engage in the business of insurance, itself, the Corporation of Lloyd's signs each policy of insurance that is issued, on behalf of the underwriters, and the **Society of Lloyd's** itself warrants that legitimate claims under the policy will be met.

[**54] As Mr. Hay Davison summarizes it, in his book:

"The Corporation of Lloyd's, created by Act of Parliament [*17] in 1871, owns the market place which is the Room, and provides facilities for the transaction of insurance business. It, and its servants, do not engage in the business of insurance. That business is carried on by the members of the **Society of Lloyd's** who collectively form, and own, the corporation... " (p. 23)

"The principal participants in the Lloyd's insurance market are the brokers who bring in the business, the active underwriters who price it and write it, the underwriting agents who manage the underwriters and get together the Names to back the syndicates, and finally, the Names themselves who, pledging their

assets without limit, provide the capacity for Lloyd's to compete as successfully as it does in the world insurance market." (p. 29)

[**55] It was into this melange of concepts that the Respondents determined to venture. They became "Names" -- members of the **Society of Lloyd's** who "back the syndicates" and who "pledging their assets without limit, provide the capacity for Lloyd's to compete ... in the world insurance market."

[**56] What, then, is the process by which they did so ?

On Becoming a Lloyd's "Name"

[**57] Historically members of Lloyd's worked within [*18] the Lloyd's market itself. Since the mid 1940's, however, there has been a rapid growth in the membership of Lloyd's and more and more of those numbers have come from outside the market. Between 1970 and the late 1980's the number of members of Lloyd's grew from 6,000 to 32,000, and about 17% of those members are from outside of the United Kingdom.

[**58] It is the responsibility of the members' agents to find potential members of Lloyd's and to guide them through Lloyd's complex admission procedures. Each Name must have a certified net worth of at least 100,000 (exclusive of his or her personal residence) and is expected to deposit cash or liquid investments to the value of 28% of premiums underwritten. The member can then join one or more syndicates and write premium income up to 3.5 times the deposit. If the Name wishes to join a particular syndicate, the members' agent will contract for the Name to take a certain line on that syndicate -- "lines" are usually expressed in multiples of 10,000 -- and the active underwriter is then empowered to accept premiums on behalf of the Name up to the total of that line.

[**59] The Name is then liable for any claims that may arise. Liability [*19] is not limited to the deposit, the certified means, or even to the premium limit. It is unlimited. As Mr. Hay Davison puts it, "Names are liable down, as the traditional phrase goes, to their last waistcoat button." (p. 28)

[**60] Becoming a member of Lloyd's is thus a significant undertaking. It requires substantial means, and it imports ominous potential liabilities. For these reasons, presumably, the process is somewhat elaborate, and can take up to a year. Potential Names must be sponsored by two existing members.

[**61] Applications are received by the **Society of Lloyd's** through members' agents. The Applications are reviewed to determine whether the applicant's certified means are adequate and whether the applicant meets certain other criteria. The Society also receives certification from the members' agent that the applicant has had the opportunity to review certain documentation, including the members' manual. When these matters have been satisfied, the potential Name goes through a process known as "the Rota interview", which is an integral part of the process of becoming a Name.

[**62] The Rota interview takes place at Lloyd's premises in London. It is attended by [*20] a representative of the Council of Lloyd's, by the members' agent and by the prospective member. A standard format is followed. In the course of the interview, the **Society of Lloyd's** ensures that the candidate has been advised and is aware of the following matters:

[**63] (a) that insurance is a risk business and losses can be made;

[**64] (b) that liability is unlimited and everything which the candidate owns is at risk to support his or her liability; that liability is not limited to funds posted or the level of means declared and that on death liability passes to the candidate's estate;

[**65] (c) that through the "reinsurance to close" of the previous year, the candidate will be assuming liability for insurance risks underwritten prior to becoming an underwriting member;

[**66] (d) that where an account has been left open at the end of the third year and not closed by reinsurance, it may be many years before the results of the underwriting are known and the account can be wound up, with the member remaining liable for his or her share of the business until the account is closed;

[**67] (e) that the candidate is encouraged to meet the underwriters of the syndicates [*21] which he or she intends to join and understands that the members' agent will make the necessary arrangement for such a meeting to take place; and,

[**68] (f) that the candidate has read his agent's annual report including the 7 year summary for the syndicates which he or she proposed to join, together with an indication of the results of open years.

[**69] At the conclusion of the Rota interview, the aspiring member is required to complete a verification form indicating his or her understanding of the matters raised in the interview -- in particular, the matters listed above.

[**70] Each of the Respondents had Rota interviews and completed the requisite verification form.

[**71] After being accepted for membership -- and after accepting that prospect -- the members must enter into three different agreements with the **Society of Lloyd's.** Of particular significance to these proceedings is the Underwriting Members' Security Agreement. It provides for the posting of security for the Name's underwriting obligations either by way of an irrevocable letter of credit or by way of a guarantee in favour of the Society -- "in either case in a form which has been approved by the Society".

[*22] Clause 2 of that Agreement states:

2. The Name hereby covenants with the Society .... as follows:

(a) ... that the Name will within thirty days of being required by notice in writing by the Society so to do pay to the Society such sum or sums of money as may be specified in any such notice from time to time given by the Society not exceeding in the aggregate the sum of [sum filled in in each particular case] and

(b) that to secure such obligations the Name will procure that the Bank [named in the Agreement] will (i) maintain in full force and effect the said Guarantee or Letter of Credit in favour of the Society and (ii) from time to time extend or renew the said Guarantee or Letter of Credit so as to ensure that the same will at any one time remain valid and enforceable for a period of not less than four years thereafter.

[**72] Any amounts received by the Society pursuant to this covenant, or the security posted for it, are to be held by the Society in trust.

[**73] Each of the Respondents executed such an Agreement, and, in accordance with the covenant therein, arranged to post letters of credit as security for their deposit obligations as Names. The Letters of Credit [*23] provided were in the form required and dictated by the Underwriting Members' Security Agreement they had entered into with the Society. Their terms and conditions are essentially as follows:

[**74] a) they are clean and irrevocable letters of credit;

[**75] b) they are payable upon presentation of sight drafts drawn on the issuing Bank and (with one exception) in pounds sterling; and,

[**76] c) they are subject to the Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce, Publication Number 400 ("UCP 400").

Lloyd's of London: A Background of Difficulty and Escalating Losses

[**77] Venerable institution though it may be, Lloyd's of London has experienced difficult times since the late 1960's. It has been rocked by a series of scandals, subjected to a major re- organization of its structure, and numbed by escalating losses in the market.

[**78] While much of this background was not "proved" at trial, in the formal sense, it was presented in the form of information contained in the Hay Davison book and in various newspaper commentaries and Reports, all of which had been provided to the Banks for their consideration [*24] in relation to the Respondents' "fraud" allegation.

[**79] Mr. Lenczner submitted on behalf of the Respondents that this background was pertinent to the Banks' decision whether to honour the Letters of Credit or not. What was put forward as a somewhat seamy history of Lloyd's in the late 1970's and early 1980's -- the scandals, the inquiries, the attempt to reverse the situation with the enactment of the new Lloyd's Act, 1982 , and the apparent inability of even Mr. Hay Davison's new broom as Deputy-Chairman and C.E.O. to cure the problems -- was said to provide the context within which the Banks were required to assess the Respondents' assertions of fraud. The Banks did not receive this claim of fraud in a vacuum, Mr. Lenczner argued. They were required to consider it in the context of this background, which Mr. Lenczner colourfully summed up in one cross-examination question by asking whether it was not true that Mr. Kenneth Randall -- the former Head of Security at Lloyd's -- had been given,

"a mandate to unravel the woeful patterns of deceit spun by the scandals at Lloyd's" ?

[**80] What, then, is some of this background, as related to the Banks ?

[**81] The particulars [*25] of the so-called scandals that plagued the Lloyd's market during the 1970's and into the 1980's are not important for the purposes of these proceedings. As I recall the evidence, they were five in number and were known by the names Savanita, Sasse, Howden, PCW, and Brooks and Dooly. Their significance is that they brought to the fore serious problems arising from the changing nature of the Lloyd's base -- a rising number of external members supplying investment funds but excluded from participation in the operation and regulation of the Lloyd's market, functions that remained in the hands of the internal members who worked within that market in London. There were increasing dangers from conflicts of interest arising because Lloyd's brokers, underwriting agents and managing agents were often the same people. The PCW and the Brooks and Dooly matters involved the use of captive re-insurance agencies owned or controlled by PCW and Brooks and Dooly insiders which enabled those insiders to take advantage of their situation and divert funds to their own purposes.

[**82] In connection with the "baby" or "preferred" syndicates operated by PCW the Disciplinary Committee of Lloyd's is reported [*26] to have said (Levin affidavit, September 3, 1991, paragraph 45):

"the Baby Syndicates were ... operated in a manner which defrauded the members of the other Syndicates managed by PCW and as a further means of dishonestly misappropriating substantial sums of money" (italics added)

[**83] I make note of this reference to fraud because, as far as I am able to determine, it is the only reference in all of the materials presented to the Banks -- at least, the only highlighted reference – where it is specifically stated that someone has defrauded someone else. There are a number of instances where Mr. Hay Davison, in his book, refers to a "plundering of the Names" in connection with these scandals, but even he states (at p. 182):

None of the recent cases at Lloyd's involve fraud, strictly speaking, because none have been brought to criminal trial. The line between fraud and gross negligence is indistinct. It is not clear by any means that all the losses in the PCW cases are fraudulent. No doubt the lack of reinsurance is dubious, and the books were not well kept, but the losses appear to be related to valid contracts of insurance validly arrived at.

[**84] A number of enquiries [*27] were spawned as a result of these difficulties at Lloyd's. The proposals of one of them -- a Report by Lord Cromer, former governor of the Bank of England, in the late 1970's -- were adopted in some respects by the then Committee of Lloyd's, but were not made

public until 1986. This decision not to publish the Cromer Report is suggested by Mr. Hay Davison, and put forward by the Respondents here, as evidence confirming Lloyd's as a secretive organization continuing to be run by insiders for the benefit of insiders.

[**85] A second Report in 1980, that of Sir Henry Fisher -- later a High Court justice laid down what Mrs. Levin has referred to in her affidavit as a charter of reform at Lloyd's", and led to the enactment of the Lloyd's Act, 1982 . The Fisher Report resulted in the divestment by Lloyd's brokers of their interests in the business of the managing agents, and pointed to certain weaknesses in the "panel auditing" process at Lloyd's. Its most significant effect, however, was the profound change which was effected by the Lloyd's Act, 1982 in the regime by which Lloyd's was governed and regulated.

The Lloyd's Act, 1982

[**86] This new structure is of some significance [*28] to these proceedings. It involved the creation of the Council of Lloyd's.

[**87] The preamble to the new Act is interesting in itself, by way of background. It states, in part:

WHEREAS -

(1) By Lloyd's Act 1871 certain persons were united into a society or corporation for the purposes of that Act and were incorporated by the name of Lloyd's (hereinafter referred to as "the Society") and various powers were conferred upon the Society by the said Act:

(5) Since 1968 the number of persons resident outside the United Kingdom admitted as members of the Society and the total number of members of the Society have both greatly increased, so that it is no longer practical or expedient for the members of the Society to exercise in general meeting the powers reserved to then by the Acts hereinbefore mentioned:

(6) It is expedient in order to enable the Society to regulate the management of its affairs in accordance with both present-day requirements and practice and the interest of Lloyd's policyholders that -

(a)there should be established a Council of Lloyd's to have control over the management and regulation of the affairs of the Society;

(b)the said Council should have power [*29] to make by-laws for the purposes of such management and regulation including by-laws making provision for and regulating the admission, suspension and disciplining of members of the **Society, Lloyd's** brokers, underwriting agents and others ...

[**88] Section 3(1) of the Act creates the Council of Lloyd's, and section 6 gives effect to the latter recital by investing the Council with "the management and superintendence of the affairs of the Society and the power to regulate and direct the business of insurance at Lloyd's" and the authority "lawfully [to] exercise all the powers of the Society". Section 3(2) provides that the Council of Lloyd's is comprised of:

a) 16 working members who are elected by the working members of the Society (i.e., those who work in the Room at Lloyd's);

b) 8 external members who are elected by the external members of the Society (i.e., those who do not); and,

c) 3 nominated members who are not Names at Lloyd's and who have been approved by the Governor of the Bank of England.

[**89] The 16 working members of the Council comprise the Committee of Lloyd's. The Act authorizes the Council to delegate certain functions to the Committee and to the [*30] Chairman and Deputy Chairmen of Lloyd's. Council has done so, and in particular, has delegated the day to day administration of the market and the power to deal with matters of urgency, but has retained responsibility for matters of policy, major financial issues, disciplinary affairs and the making and amending of by-laws.

[**90] The Society and Council of Lloyd's are named as the beneficiaries of the Letters of Credit here in question. The one exception is the Letter of Credit of Mr. Munro, with respect to which the beneficiary is the Corporation of Lloyds. The **Society of Lloyds** and the Corporation of Lloyds would appear to be one and the same, however, as "the Society" is defined by the various Lloyd's Acts to mean "the society incorporated by the Act of 1871 by the name of Lloyds".

[**91] Mr. Lenczner's central submissions, as I apprehend them, are these:

[**92] a)that by virtue of the structure of Lloyd's, as established by the Lloyd's Act , 1982, the Council of Lloyd's -- and, through it, the **Society of Lloyd's** -- controls and is responsible for everything which transpires with respect to the affairs of the Society and the regulation and direction of the business [*31] of insurance at Lloyd's;

[**93] b)that as a result of the regulatory structure governing that business, the council -- and through it, the Society -- are clothed with all of the information and knowledge necessary to equip them to carry out the foregoing responsibilities;

[**94] c) that the Society and Council either deliberately and deceitfully, or recklessly and without regard to the consequences of what they were doing -- i.e., fraudulently - - failed to carry out those responsibilities and failed to disclose material information to prospective Names, in connection particularly with the specific areas outlined earlier where it is asserted that fraud has been established in a "clear or obvious" fashion to the knowledge of the Banks; and, accordingly,

[**95] d) that the Banks ought not to have honoured Lloyd's calls on the Letters of Credit and are not entitled to be reimbursed by the Respondents for having done so.

[**96] Had the Society and Council of Lloyd's not failed in carrying out their regulatory obligations and had the Respondent Names known of the information which was not disclosed, the argument concludes, they would not have invested and become Lloyd's Names. [*32]

[**97] I turn now to a more detailed consideration of the particular areas where it is said that "fraud" has been established.

C. THE PARTICULAR AREAS OF "FRAUD"

[**98] The specific areas in which it is submitted that fraud had been "established" to the knowledge of the Banks have been summarized earlier in the Reasons. To re-capitulate, they are:

[**99] i)Asbestosis Claims

[**100] ii)The "LMX Spiral"

[**101] iii)The Use of "Time and Distance" Policies

[**102] iv)The Feltrim Syndicate

[**103] v)Overwriting

[**104] vi)The Misuse of Trust Funds

[**105] vii)Misdescription of the business of certain Syndicates as engaging in Excess of Loss re-insurance whereas they were, in fact, engaging in catastrophe re-insurance

[**106] viii)The misuse of combined reinsurance, and

[**107] ix)Lloyd's knowledge and concealment of long tail liabilities which the Names unknowingly assumed when they became Names.

[**108] As I have noted above, the Respondents assert that the Banks were obliged to consider these matters in the context of, and against the background of the history of scandal and difficulty afflicting Lloyd's in the 1970's and 1980's as outlined [*33] above. I will deal with each of these areas in turn.

(i) Concealment of the Extent of Asbestos Claims, and the Failure to Ensure that Syndicates Took Adequate Reserves

[**109] During the late 1970's and early 1980's claims for asbestos related injuries flooded the insurance markets of the world. The Lloyd's market felt much of this impact.

[**110] Many of these claims emanated from the United States, where courts began to apply a "manifestation" basis for determining whether insurance policies provided coverage; that is to say, coverage was provided by policies in place at the time the injuries manifested themselves rather than at the time when exposure to the asbestos occurred. since asbestos-related injuries most often manifested themselves many years -- often several decades -- after the injured person was exposed, this meant that underwriters of insurance in, say, the mid-1980's were being required to respond to claims relating to injuries that had been caused, in some cases, as long ago as the 1940's. What was particularly frightening for the insurance industry was that these claims were coming forward by the late 1970's and early 1980's in large -- and ever-increasing [*34] -- numbers; and the full extent of the industry's exposure could not be predicted or quantified.

[**111] This state of affairs, needless to say, was a matter of grave concern in the Lloyd's market. A Report prepared for Lloyd's Underwriters by the American law firm of Lord Bissell and Brook in May 1980 with respect to potential exposure under reinsurance coverages for Johns Manville Corporation, confirmed concerns regarding the problem of reserving against asbestos claims. It said, in conclusion:

Finally the most insoluble problem of all stems from the fact that due to the long latency periods of the asbestos diseases it is impossible to predict the number of claims that will ultimately be brought against the assured.

[**112] The seriousness of mounting asbestos claims led to the establishment of an Asbestos Working Party in mid-1980 for the purpose of developing a co-ordinated approach by underwriters and law firms for dealing with such claims in the Lloyd's market. Creation of the Asbestosis working Party was communicated to the market, and to managing agents in particular, in a circular dated 5th August 1980, which stated, in part:

The setting up of this working party [*35] will in no way impair your ability to participate in the handling of those matters in which you are involved, but is more intended to co-ordinate the Market's interest on a broad basis ...

It must be emphasized that the potential involved here is so large and the issue so complicated that we cannot allow a "muddle through somehow" approach ...

[**113] There were meetings involving members of the Committee of Lloyd's concerning the asbestos problem in 1981. The minutes of one, in particular, are relied upon by the Respondents. On 10th November 1981 the Advisory Panel of Auditors met. Mr. W.N.M. Lawrence, then Deputy Chairman of Lloyd's with responsibility for audit matters was present, as was Mr. Kenneth Randall, then responsible for Lloyd's audit department. Asbestosis claims were discussed at the meeting. Mr. Kiln, chairman of the Lloyd's Audit Panel reported that claims were being made on notices as far back as 1947. Mr. Lawrence reported that a data bank was being produced which would contain details in respect of the 10 or 12 major assured with all years of cover, and that the loss adjusters would then be able to make some estimate of underwriters, lines on such risks.. Mr. [*36] Kiln is recorded as pointing out that he did not wish to see mention of these specific claims in the Audit Instructions.

[**114] This latter comment is relied upon by the Respondents as evidence of Lloyd's penchant for secrecy and an attempt by Lloyd's to prevent disclosure of the extent of the asbestosis problem. The Bank representatives who testified, however, took it at worst as ambiguous and at best as simply a reference to the specific 10 or 12 assured mentioned.

[**115] In any event, Lloyd's panel auditors were particularly worried because they felt that potential liabilities could not be quantified. This anxiety on their part led in February 1982 to a letter being sent which has assumed some importance in these proceedings.

[**116] On February 24, 1982, the accounting firm of Neville Russell wrote to the Manager of the Audit Department at Lloyd's, on behalf of itself and the other five firms who were members of the Lloyd's audit panel (the "Neville Russell letter"). The letter is important to the Respondent's case, and it sets out a useful summary of the severity of the asbestos situation. I reproduce it in full:

Dear Sir

ASBESTOSIS

We are writing this letter, not [*37] only on behalf of ourselves, but also on behalf of the following firms of panel auditors:

Arthur Young McClelland Mooras & Co
de Paula, Turner, Lake & Co
Ernst & Whinney
Futcher Head & Gilberts
Littlejohn & Co

A substantial proportion of our Syndicate clients have losses, or potential losses, arising from asbestosis and related diseases.

It appears that although, in respect of direct insurance of the main carriers and reinsurance of American insurers, Syndicates have received some notification of outstanding claims, they are unable to quantify their final liability with a reasonable degree of accuracy for the following reasons:

(i)You have informed us that there have been approximately 13,000 individual claimants. Total exposure to the problem appears to be considerably in excess of this figure.

(ii)The Courts have not yet finally decided on whether the exposure or manifestation basis is applicable.

(iii)The losses are being apportioned over carriers on an "industry" basis. If one of the carriers has losses in excess of its insurance cover (as seems likely) then it could go bankrupt. It appears that its share of the industry loss could be apportioned over the remaining [*38] companies.

(iv)Most Syndicates are not very certain of their reinsurance recoveries.

(v)Most Syndicates will incur losses on their own writings of reinsurance business. [Emphasis start] Very little of this has been advised so far[Emphasis end].

The Audit Instructions (Clause 3) require that if there are any factors which may affect the adequacy of the reserves, then the auditor must report to the Committee and obtain their instructions before issuing his Syndicate Solvency Report.

We consider that [Emphasis start] the impossibility of determining the liability in respect of asbestosis falls into this category[Emphasis end] and we accordingly ask for your instructions in this respect.

Yours faithfully.

(emphasis added)

[**117] The Neville Russell letter elicited the following response from the Deputy Chairman of Lloyd's, Mr. Murray Lawrence, dated 18th March 1982 (the "Murray Lawrence letter"). Considerable emphasis is placed on this letter by the Banks, and it, too, is reproduced here, in its material respects:

Dear Sir(s)

Asbestosis - Lloyd's Audit at 31st December, 1981 Potential claims arising in connection with Asbestosis represent a major problem for insurers [*39] and reinsurers. It is therefore all the more important that the reserves created in the Lloyd's Audit at the 31st December, 1981, fairly reflect the current and foreseeable liabilities of all syndicates. [Emphasis start] I should stress that the responsibility for the creation of adequate reserves rests with Managing Agents[Emphasis end] who will need to liaise closely with their Auditors. Clearly, individual circumstances will vary, but it is felt that the following broad guidelines may be helpful to Underwriters, Managing Agents and Auditors in agreeing equitable reserves as at 31st December, 1981, and ensuring, so far as possible, a reasonably consistent approach to this problem.

1.[Emphasis start] Reserves for Asbestosis liabilities should be separately identified and disclosed to Auditors. This applies for both the closing and open years[Emphasis end].

3.It is in the area of reinsurance writings that the information available may be least complete. Nevertheless, the Committee believes that some information is now available within the market and Underwriters and Managing Agents should discuss with their Auditors the steps they have taken to quantify and reserve for losses [*40] which may arise on an Excess of Loss or Pro Rata basis as a reinsurance of American or other insurers. In this connection, Underwriters should attempt to identify reinsureds on whom Asbestosis claims are likely to fall and to seek their opinion as to the basis on which they intend to submit claims on their reinsurance contracts together with the reserves which they are carrying at the present time and an estimate of possible future liabilities.

4.The Committee is aware of the legal argument whether liability arises on the basis of "exposure" or manifestations. It is not, however, for the Committee to express an opinion as to which is correct. For the purposes of reserves at 31st December, 1981 Managing Agents are strongly advised to carry a reserve which is the higher of the alternatives.

5.[Emphasis start] An IBNR (*1) "loading" should be carried for those claims not specifically advised but which could come to light in the years ahead[Emphasis end]. The decision regarding the appropriate IBNR percentage is a matter for the Agent and his Auditor to resolve dependent upon the circumstances of each case. It would be inappropriate for the Committee to lay down a minimum loading [*41] but, it appears that this loading should be substantial to reflect unreported cases on the direct account and incomplete information on the reinsurance account. ...

[**118] (*1) IBNR - "incurred but not reported"

7.A syndicate underwriting London Market Excess of Loss business should make particular and comprehensive efforts to ascertain the extent of its possible liability going beyond those claims which have been advised at 31st December, 1981, and these would be fully disclosed to and discussed with Syndicate Auditors. The same requirement should apply to specialist Personal Stop Loss syndicates.

8.[Emphasis start] Where the reserve for Asbestosis represents a material proportion of the total reserves of the syndicate. Agents should consider whether or not to leave the account open. It is the Agent's responsibility to ensure that the reserves provided for Asbestosis are sufficient to meet the Syndicate's liabilities regardless of whether the account is closed or left open[Emphasis end].

9.[Emphasis start] Managing and Members Agents are strongly advised to inform their Names of their involvement with Asbestosis claims and the manner in which their syndicates' current [*42] and potential liabilities have been covered[Emphasis end]. I would urge you to discuss the contents of this letter with your Auditor before deciding what further action, if any, is necessary for you to take. ... This letter has been sent to all Underwriting Agents and Active Underwriters, with copies for information to all Panel Auditors.

Yours faithfully,
Murray Lawrence
(emphasis above added)

[**119] In a Statement prepared by Kenneth Randall for the Respondents and forwarded to the Banks regarding the Neville Russell letter and the Murray Lawrence letter (although not until just prior to the final call on the Letters of Credit), Mr. Randall said:

I have no doubt whatsoever that Lloyd's took the problem of reserving for asbestos related claims very seriously indeed. The letters sent to auditors, underwriting agents and active underwriters spelled out very clearly the steps to be taken in establishing the extent of their exposure to such claims when drawing up the accounts at 31st December 1981.

[**120] The references in the Murray Lawrence letter to syndicate accounts being "closed" or "left open" require explanation. Failure by most of the Lloyd's syndicates [*43] to leave their underwriting years "open", as I understand the evidence, is said to be a major reason for the substantial losses suffered by Lloyd's Names, such as the Respondents, who underwrote insurance risks in later years.

[**121] A Syndicate's account for a given year is generally left "open" for 3 years, after which a closing reserve is calculated by the active underwriter. The account is then "closed" through the purchase of a reinsurance policy known as "reinsurance to close", designed to cover the reserve. Most of the premiums funds remaining in the premium trust fund for the year in question, after the reserve, will be required to purchase the reinsurance to close. The balance is paid out to the underwriting members of the Syndicate as profit.

[**122] The purpose of leaving the accounts open for 3 years is to defer the distribution of profit until the pattern of claims' settlement for the syndicate year in question can be determined with reasonable clarity. If that clarity does not exist the accounts may be left open for a fourth year or longer, until the closing reserve can be calculated with sufficient certainty.

[**123] Thus, reinsurance to close is simply a [*44] means whereby the underwriting members of a particular syndicate year pass the risk of the losses still to accrue to that account after closing to another group of underwriting members, in exchange for a reinsurance premium and the assignment to the reinsuring members of all rights pertaining to the reinsured business. "In practice", according to Mr. Hay Davison's book (p. 36),

"the other party with whom the reinsurance to close policy is usually taken out is the same syndicate, but for the next year of account. In fact, a Name participating on the syndicate for a given year contracts with the same syndicate for the next year of account and is thus, in a sense, contracting with himself [or herself]".

[**124] The assessment of the premium for the reinsurance to close is an important and difficult exercise. It involves the achievement of equity as between the reinsured members of the syndicate being closed and the reinsuring members. The reinsured must not pay too much and the reinsurer must not receive too little, by way of premium. Where the latter is the case there is a serious problem, of course; the reinsuring members of the subsequent syndicate years must bear the continuing [*45] losses without adequate funds to pay those claims. This is, in fact, what happened in the asbestos syndicates at Lloyd's.

[**125] Because of the potential extent and the unquantifiable nature of the asbestos claims, Syndicates providing coverage for such losses were faced with two classic choices: they could refuse to sign off the reinsurance to close, because of the impossibility of calculating the appropriate reserve, and leave the syndicate "open" -- thus exposing themselves to huge potential losses; or, they could "close" the account years, taking massive reserves that would bankrupt them and, because of the numbers

involved, effectively bankrupt the Lloyd's market as well. Certainly Mr. Randall, who was the manager of the Underwriting Agents and Audit Department at Lloyd's at the time, expected most syndicates to be left open. in the foregoing Statement, Mr. Randall said:

In view of the concern which had been expressed by Panel Auditors about the asbestos claims position, I fully expected that many syndicates would take the decision to leave their 1979 year open and that others would report substantial losses. In the event, I was surprised that this prediction was not fulfilled.

[*46] Looking back on the situation now, I an drawn to the conclusion that many syndicates failed to comply with Lloyd's instructions, particularly the requirement to research asbestos exposures arising in connection with their reinsurance writings.

[**126] Indeed, it appears that most Syndicates were not left open. The evidence indicates, in fact, that very few were. Perhaps understandably, given the draconian extremes of the two foregoing choices -- and looked at from the perspective of the times -- Syndicate managers seem to have chosen a middle route. Contrary to the caution expressed by the Asbestos Working Party in the circular quoted above, they attempted "to muddle through". They closed the 1979 and other accounts, taking the reserves thought to be needed over a series of years, thus spreading the losses over the Names who underwrote the Syndicates throughout the 1980's.

[**127] Ian Posgate testified regarding this process. He was called by Mr. Lenczner. Mr. Posgate is an active underwriter and manager of syndicates at Lloyd's -- a somewhat flamboyant one, it seems. Described in the Hay Davison book (at p. 56) as "an undoubtedly popular star with a large number of external [*47] members" -- a description he did not deny in the witness box -- Mr. Posgate was the largest marine underwriter at Lloyds in the early 1980's, responsible for about 25% of Lloyd's marine business at the time. From 1982 to 1984 he was a member of the Committee of Lloyd's. Wrote Mr. Hay Davison (p. 56):

Posgate was a controversial figure in the Lloyd's market. His free-wheeling and aggressive underwriting methods had earned him the enmity of his competitors in the marine market on the floor of the Room. He was seen as being one who would break conventions and cut rates to get business - he was certainly not a team player. But his popularity at Lloyd's was great enough for him to be elected to the committee at the end of 1981.

[**128] Mr. Posgate testified that the members of the Committee discussed the matters raised in the Neville Russell letter of February 24, 1982 and the Murray Lawrence response of March lath, but that they did not discuss the question of leaving the accounts open. The Committee receives copies of the annual reports of each Syndicate and publishes Lloyd's global accounts, which are an accumulation of net premiums and net claims and carry forwards of all the Syndicates [*48] at Lloyd's. Mr. Posgate confirmed the testimony of Mr. John Rew, the editor of the Chatset Tables in which the Lloyd's accounts are published, that the Committee would know from this process which Syndicates had been left open and which had not. He stated that no disclosure was made by the Committee that the Syndicates had not left the 1979 and following years open.

[**129] On the other hand, Syndicates which were left open included his own, he testified. Some reserves were taken each year in those Syndicates, and it was his view -- expressed to others in similar positions -- that the prudent way to handle the problem was to "do it gently over 10 years", in circumstances which would allow for development of a greater knowledge of the size of the potential claims. In the long term the burden would fall on the Names who underwrote the Syndicates in the years between 1982 through 1988. In hindsight, he acknowledged, equity was not done in closing the 1979 year into 1982, but at the time, he said, they believed that it was. He stated in Re-examination that if underwriters decide to take a 10 year middle line as he did, instead of either taking the full reserve or leaving the syndicate [*49] open, they have to be extremely careful that they can do so, or they run the risk of facing allegations of fraud or recklessness.

[**130] It is clear from the evidence that the Society and the Council of Lloyd's -- directly, and through the Committee of Lloyd's -- had the ability and the duty to regulate the Lloyd's insurance market; that the Committee received market information on an almost daily basis, and annual statements from the Syndicates; and that the Council and Committee had the power and authority to oblige Syndicates to leave their years open, but did not do so. In addition, according to the testimony of Mr. Newton Grant – a chartered accountant called as an expert on what should have been included in the Lloyd's global accounts -- there was no disclosure in those accounts of the failure of the Syndicates to leave the accounts open.

[**131] Newton Keene Grant, O.B.E., was called by Mr. Lenczner as an expert on disclosure requirements for corporate financial statements. He is a very experienced chartered accountant who has held numerous responsible positions on various professional bodies in the United Kingdom. It was his opinion that the Council of Lloyd's should [*50] have ensured that the Lloyd's global accounts contained a note respecting the potential asbestos liabilities. They did not, and therefore misrepresented the state of the company's accounts, in his view. In examination in chief, Mr. Grant testified that he thought the failure to ensure such disclosure, in view of what he saw as "a clarion call to arms" in the Neville Russell letter, constituted a total disregard for the consequences of non-disclosure. In cross- examination, however, he stated that he was not saying that such a material misstatement was necessarily fraud; it could be that, or it could be negligence, or even an innocent mistake. He would

have had to do a lot more work and examine a lot more material before he could opine on fraud, he conceded.

[**132] The Lloyd's global accounts were not provided to the Banks until just before the trial of these proceedings.

[**133] The Respondents' position with respect to the asbestos issue is essentially twofold, as I have already indicated:

[**134] a) first, that Lloyd's knew about, and concealed the extent and unquantifiable nature of past asbestos liabilities, which the Names, unknowingly, assumed when they became Members [*51] of Lloyds; and,

[**135] b) secondly, that Lloyds represented that reserves were adequate when it knew insufficient and inadequate reserves had been set aside for past asbestos liabilities.

[**136] I will return to an analysis of this position, in the context of the applicable law, after an outline of the facts pertaining to the other areas of alleged fraud. I turn now to a description of what has been referred to as "the LMX Spiral".

(ii) The LMX Spiral

[**137] LMX business is a form of reinsurance developed and largely transacted in the London market by both corporate reinsurers and Lloyd's syndicates. "LMX" stands for "London Market Excess of Loss" reinsurance. Its basis is essentially the same as normal excess of loss reinsurance i.e. a reinsurer agrees to indemnify a reinsured against losses in excess of a predetermined figure. Reinsurers, themselves, may wish to lay off some of their risk, however, and take out their own reinsurance. Reinsurance of reinsurance is called "retrocession". The retrocession of excess of loss reinsurance developed as a mechanism to spread exposures more widely.

[**138] In the London retrocession market a new feature developed during the [*52] 1980's. Many of those using that market to obtain reinsurance began to accept such reinsurance business themselves from other participants in the market. The result was the passing of risks around a circle -- the creation of a "spiral" -- through the interchange of such business. LMX reinsurers frequently reinsured at one layer risks that they had substantially transferred outwards in an earlier layer. Risk was thus concentrated, as one became more intensely entwined in the "spiral", rather than being dispersed, which is the central purpose of reinsurance.

[**139] Names on the small number of syndicates involved in this practice, particularly those exposed without adequate protection at the top of the "spiral", were at substantial risk of massive losses. Moreover, such massive losses occurred as a result of the impact of an apparently unprecedented number of catastrophe losses which hit the market between 1987 and 1990 -- Northern European storms in 1987; the Piper Alpha oil rig disaster and Hurricane Gilbert, in 1988; Hurrican Hugo, the San Francisco Earthquake, the Exxon Valdez spill and the Phillips Petroleum catastrophe, in 1989; and more Northern European storms, in 1990. [*53]

[**140] The "LMX Spiral" acquired a certain notoriety in the insurance markets, and in the British Press. Two Enquiries were commissioned to look into it -- one chaired by Sir David Walker and the other by Sir Patrick Neill -- and each issued a Report. I shall return to these Reports in more detail in the analysis section of these Reasons. Much of the foregoing description of the Spiral -- which I think is not contentious -- has been taken from the Walker Report. Sir Patrick Neill characterized LMX as "operating in the event of catastrophe so as to negate the basic principle of insurance". He said:

It is a notorious fact that a group of Lloyd's syndicates (and some company reinsurers) suffered breathtaking losses as a result of the catastrophes which occurred in 1987 to 1990. The syndicates were those which were heavily involved in the LMX market. The Walker Report ... found that in the 1988 year of account 95% of the catastrophe losses affecting Lloyd's fell on 12 syndicates and in 1989 79% fell on 14 of them.

This concentration of such a high percentage of the losses on such a small number of syndicates, taken together with the now established facts about the development of [*54] the spiral ... conclusively provide that the LMX spiral operated in the event of a catastrophe so as to negate the basic principle of insurance , which is the spreading and sharing of risk, and instead focused the losses on to the few who had underwritten the higher levels of exposure and had failed to effect sufficient reinsurance. (italics added)

(Neill Report, Paragraphs 15.12 and 15.13, p. 800)

[**141] The Respondents submit that the LMX spiral constituted a fraudulent practice because of its concentration of risk amongst a small group of reinsurers instead of spreading the risk, which is the normal principle of insurance and reinsurance. They submit that the Society and Council of Lloyd's had complete knowledge of the LMX practice and the ability to stop it, by virtue of its regulatory control over the market. The practice, however, was allowed to continue, to the great detriment of the Names who were members of the Syndicates in question.

(iii) Time and Distance Policies

[**142] In April 1992, prior to any of the calls on the Letters of Credit, the Respondents notified the Banks that a mechanism used in the Lloyd's market, known as a Time and Distance Policy, [*55] was being misused, to the knowledge of Lloyd's, in a way which permitted syndicates to overstate profits and to mask losses. These allegations pertained, in particular, to those Names -- including some of the Respondents -- who had underwritten certain of the Gooda Walker Syndicates. These Syndicates, the

Financial Times of London reported, had "specialized in catastrophe reinsurance business and in 1989 and 1990 delivered some of the worst losses in Lloyd's recent history." Their resort to the use of time and distance policies became one of the controversial issues surrounding their liquidation.

[**143] In support of this allegation of fraud, the Respondents provided the Banks with an affidavit of Kenneth Randall which had earlier been filed in proceedings in the U.K. High Court of Justice, known as Boobyer v. The **Society of Lloyd's** et al. , together with copies of a number of articles in the London press respecting the affidavit and time and distance policies generally. Mr. Randall, it will be recalled, was the manager of Lloyd's Underwriting and Audit Department in 1982, at the time of the Neville Russell and Murray Lawrence letters. From 1982 to 1984 he was Head of Regulatory [*56] Services at Lloyd's. The affidavit describes steps which Mr. Randall's company had taken to conduct a preliminary investigation of the Gooda walker time and distance programme.

[**144] According to the Randall affidavit, a time and distance policy is a contract of indemnity whereby, in return for a premium and in the event of the payment of claims at a predetermined level, the reinsurer agrees to indemnify the reinsured in respect of such claims up to an agreed sum of money equal to the amount of the premium paid plus compound interest less the reinsurer's margin for expenses and profit. In other words, the syndicate pays a premium and in return receives a fixed and predetermined (and, presumably, larger) amount at a predetermined time in the future. In this way the syndicate assures itself of a predictable cash flow at the future time, for the payment of claims at that time.

[**145] There are also tax implications to this form of coverage. The premium is deductible, provided that credit is at the same time taken by the purchasing syndicate for the full amount of the indemnity. However, the difference between the amount of the premium and the indemnity gives rise to an immediate [*57] "gain" which will increase the profits of the syndicate and reduce its losses, thus masking the true underwriting picture of the syndicate.

[**146] At the same time, time and distance policies have the disadvantage of locking in the syndicates premium funds for the period in question prior to the predetermined settlement dates. As well, if the time and distance policies are commuted prior to the predetermined settlement date -- as was the case with the Gooda Walker programme -- one group of Names can be benefitted at the expense of others.

[**147] At trial Mr. Lenczner advanced the argument that time and distance policies were not insurance at all, but rather banking or financing instruments, and that the **Society of Lloyd's** was fraudulent in allowing the Syndicates to engage in an activity which did not amount to insurance. This argument does not appear to have been put forward to the Banks prior to trial as a reason for dishonouring the Letters of Credit. Even if it had been, however, I do not see how it could have been accepted as establishing fraud in any fashion, because Mr. Randall's affidavit itself rejects the notion. He states, at paragraphs 13 and 15:

13.Time and [*58] distance [Emphasis start] policies[Emphasis end] are used extensively in the Lloyd's market (as well as in other [Emphasis start] insurance markets[Emphasis end]). In general, syndicates aim to match the [Emphasis start] recoveries[Emphasis end] to be obtained from the reinsurer under the policy to the anticipated cash needs of the syndicate [Emphasis start] to meet claims as they fall due[Emphasis end]....

15.[Emphasis start] Although it has financing characteristics, a time and distance policy is Generally accepted in the London insurance Market and by Lloyd's as a contract of reinsurance[Emphasis end].

(emphasis added)

[**148] I shall return to the submission that the **Society of Lloyd's** was fraudulent in permitting the misuse of time and distance policies to permit the Gooda Walker Syndicates to overstate their profits and to mask losses, in the analysis portion of these Reasons.

(iv) The Feltrim Syndicates

[**149] In the Fall of 1986, Feltrim Underwriting Agencies Limited ("Feltrim") was approved by Lloyd's as a managing agent, to commence underwriting insurance for the 1987 year of account of Syndicates 540/542. Mr. Patrick Feltrim Fagan, who had been a junior [*59] underwriter with the by then disgraced PCW Syndicate, was the lead active underwriter for Feltrim 540/542. Hence their name.

[**150] In connection with these Syndicates, the allegations of the Respondents that were asserted to the Banks as establishing fraud on the part of the Society and Council of Lloyd's, as I have previously summarized them, were these:

[**151] a) that Lloyd's ought not to have approved and permitted the registration of Feltrim to manage the Syndicates, in light of the connection with the earlier PCW scandal;

[**152] b) that Lloyd's secretly caused the removal of approximately 24 million from the reserves of the Syndicates in the Fall of 1986 for the purposes of making a PCW scandal-related settlement with members regarding the 1983 year of account, and failed to disclose this removal to potential Names who were joining in later years;

[**153] c) that the removal of the 24 million left Feltrim 540/542 with a reserves to premium ratio which did not meet Lloyd's own by-law requirements;

[**154] d) that Lloyd's permitted Feltrim to misdescribe itself as writing excess of loss insurance, whereas it was in reality writing catastrophe, or LMX insurance; [*60] and,

[**155] e) that Lloyd's permitted the Feltrim Syndicates, along with the Gooda Walker Syndicates, to become involved in the LMX spiral which, it is said, provided only illusory and not real reinsurance for catastrophes.

(a) The Scandal Connection

[**156] As stated above, the lead active underwriter for the Feltrim Syndicates was Patrick Feltrim Fagan. Mr. Fagan had been the junior underwriter to Peter Cameron Webb of the disgraced PCW Syndicate which had been the centre of the earlier PCW scandal. He himself had not been tinged by the scandal, however.

(b) Removal of the 24 Million from the Feltrim Reserves

[**157] In the Fall of 1986 and Spring of 1987 the Council of Lloyd's completed a settlement with Names involved in the PCW Syndicate and certain other Syndicates (known in the settlement documentation as Peripheral Syndicates"). Feltrim 540 for the 1983 year of account was one of the Peripheral Syndicates. As part of the settlement agreement, the 24 million of assets pertaining to the 1983 year of account were removed from the Feltrim 540/542 reserves, along with the liabilities relating to the 1983 Year (which apparently exceeded the 24 million) .

[**158] [*61] The settlement was some time in its negotiation and completion, however, and, although the 24 million was removed from the reserves as at December 31, 1986, this news was not made public until Spring of 1987. In short, potential Names who were going through Rota interviews and examining the 7 year history of the Feltrim Syndicates during that period, would not have known that the assets of Feltrim 540/542 were approximately 4 million instead of the indicated 28 million. It is upon this non-disclosure that the Respondents place particular emphasis in urging there was fraud on the part of the Council of Lloyd's. They say the failure to disclose deceived Names who underwrote Syndicates 540/542 for the 1987 and following years and that they would not have become members had they known the true state of affairs.

[**159] The Feltrim Managing Agent's Report, which was released on June 2, 1987 briefly explains the settlement and the removal of the 1983 assets and liabilities to the new Syndicate (Lioncover 9001) which was assuming responsibility for the 1983 year. It is clear from the Balance Sheet contained in that Report that the "run-off account balance 1983 after 3 years" which stood [*62] at 23,882,869 as at December 31, 1985 had been reduced to zero as at December 31, 1986. AT p. 2, the Report says:

Syndicates 540/542 - 1983 Year of Account

Feltrim Underwriting Agencies Ltd. did not assume responsibility for the 1983 year of account which was kept open at 31st December, 1985 pending the resolution of a dispute concerning an outward Quota Share reinsurance with the PCW Non-Marine Syndicate 157.

At 31st December, 1986 the management of the 1983 year of account of Syndicate 540/542 was vested in Additional Underwriting Agencies (No. 3) Ltd. Under the terms of the Settlement offer 2 made by Lloyd's on 9th April, 1987 [Emphasis start] Names on the Syndicate for 1983 will. if they accept and the offer becomes unconditional. receive the surplus declared at 31st December. 1985. but currently withheld. The Assets and Liabilities of the 1983 Year of account will then pass to a new Syndicate. No. 9001[Emphasis end].

As a result the 1984 year of account has not received a Premium to close the 1983 year of account and as a consequence has no liability in respect of business underwritten for any account prior to 1984.

(emphasis added)

(c) Reserves to Premium Ratio [*63]

[**160] It is argued by the Respondents that the removal of the 24 million reduced the reserves of Feltrim Syndicates 540/542 to approximately 4 million, leaving it with a reserves to premium ratio well below the one to one ratio required by Lloyd's own guidelines. I do not believe, based on the materials before me (and which had been given to the Banks), that this position is accurate. The security ratios required are not as between premium income and reserves , but rather as between premium income and surplus . The latter ratio is required to be one to one. To determine surplus, however, it is necessary to have information about the members' entire means available to support the underwriting. NO such information was available, and, accordingly, it was not possible to determine whether there had been any breach of Lloyd's guidelines respecting security ratios.

(d) Misdescription of the Feltrim Syndicates

[**161] The Respondents contend that the Council of Lloyd's failed to follow its own guidelines and permitted the Feltrim Syndicates to describe themselves simply as Excess of Loss reinsurers rather than as LMX reinsurers. Excess of Loss was said to be a relatively safe form [*64] of reinsurance, while LMX reinsurance, as previously outlined, is significantly more risky and concentrates upon catastrophe reinsurance.

[**162] A review of the Feltrim Managing Agent's Report, referred to above, indicates that the Managing Agent, at least, did describe the Syndicates as excess of loss reinsurers.

[**163] The Banks submit that they were not provided with any documents or other evidence which established, one way or another, that the Feltrim Syndicates were misdescribed. They were provided with a copy of the January, 1990 Report of Lloyd's General Review Department on Feltrim, which concluded that the agency had complied with Lloyd's by-laws, regulations and codes of practice.

(e) The LMX Spiral

[**164] I have outlined the nature of the LMX Spiral, and the issues surrounding it earlier in these Reasons. The Feltrim Syndicates and the Gooda Walker Syndicates were particularly affected by losses incurred in the LMX market.

(iv) "Overwriting" by Gooda Walker Syndicates

[**165] It was also asserted that the Council of Lloyd's had the regulatory power to stop overwriting by agencies, and that it failed to do so in the case of the Gooda Walker Syndicates. [*65] "Overwriting" is the acceptance of premiums beyond authorized premium limits.

[**166] There is no merit in this allegation as a basis for established fraud sufficient to justify the dishonouring a letters of credit, in my view, and I will not deal with it further. While overwriting is reported to have existed, it is not an uncommon phenomenon and it is something, according to Mr. Hay Davison's book (pp. 134-137), which can even befall a thorough and conscientious underwriter. The fault is not necessarily deliberate or reckless, and -- even if it were -- there is nothing in the evidence to connect the conduct alleged with the Society or Council of Lloyd's in this case.

(v) Combined Reinsurance

[**167] in the affidavit of Mrs. Levin which was filed as part of these proceedings, and earlier provided to the Applicant Banks in support of the fraud allegation, it is asserted that Lloyd's failed to follow its own by-laws and regulations by allowing the active underwriter to use a combined reinsurance programme to reinsure Feltrim Syndicates 540/542 and 847. There is not a great deal of evidence to support this position. It could not, in my opinion, form the basis for the establishment [*66] of clear or obvious fraud on the part of the Society or Council of Lloyd's, and I will pursue it no further.

[**168] I note that the Report of Sir Patrick Neill, published and provided to the Banks -- in part -- later, came to no conclusion that the joint syndicate reinsurance programme was a fraudulent practice of the underwriter, Mr. Fagan, much less of the Society or Council of Lloyd's.

(vi) Misuse of Trust Funds

[**169] By letter dated February 14, 1992 Mr. Lenczner provided the Banks with information which, he contended, was further evidence of fraud on the part of Lloyd's. The information related to a proposed transfer of trust funds from Feltrim Syndicate 540/542 to Feltrim Syndicate 847. Mr. Lencnzer asserted that it was a misappropriation of funds to use trust funds standing to the credit of one syndicate made up of specified members for the purposes of another syndicate which has a different membership.

[**170] In support of this contention, the letter enclosed an internal memorandum, dated 23rd January 1992, from Additional Underwriting Agencies (No. 7) Limited to all supporting agents - Syndicates 540/542 and/or 847. Additional Underwriting Agencies (No. 7) [*67] Limited had assumed responsibility for the management of those Syndicates. Item 2 of the Memorandum dealt with "Combination of Trust Funds (and US$)". It states:

Although both the and US$ Trust Funds for Syndicate 540/542 are now in credit, Syndicate 847 has overdrafts in both currencies. These overdrafts are more than covered by unpaid cash calls which are approximately 30m; the corresponding figure for Syndicate 540/542 being in the order of 21m. [Emphasis start] We are under constant pressure from Lloyd's to clear Syndicate 847's US$ overdraft[Emphasis end], and given that further external finance is not available it is the intention to combine the US$ and Trust Funds of Syndicates 847 and 540/542 as soon as possible. ..is action will result in a small surplus in US$ and a reduced overdraft in Sterling. This arrangement, in terms of interest cost/interest receipt will benefit both Syndicates and although involving additional interest apportionments, maintaining equity between Names will not present a problem. (italics added)

[**171] This allegation can be disposed of at this point, too. Basic principles concerning trust law preclude the application of monies held [*68] in trust for one group of people in favour of another group of people, at least without the consent of the first group of trust beneficiaries. It is a significant leap, however, from "constant pressure from Lloyd's " to clear an overdraft, on the one hand, to an intention on the part of the Society or Council of Lloyd's to misapply trust funds in order to do so, on the other hand. There was no other evidence to indicate that any such plan existed on the part of Lloyd's as opposed to the Underwriting Agency , or, indeed, that any such transfer actually took place.

[**172] This allegation could not amount to clear or obvious fraud established to the knowledge of the Banks sufficiently to justify the refusal to honour the Letters of Credit, in my opinion.

D. MATERIALS PROVIDED TO THE BANKS

[**173] Next, in this review of the facts pertaining to the fraud defence, it is important to delineate as briefly as possible the nature and extent of the documentation and materials provided to the Banks in their effort to establish clear or obvious fraud on the part of the Society or Council of Lloyd's. It is on the basis of such documentation and materials, that the case for established [*69] fraud must have been made out.

[**174] The Applicant Banks were provided with a great deal of materials by the Respondents in the course of this exercise but not all of it at the same time. When the different materials were provided to the Banks is of some significance in the proceedings because Lloyd's has made calls on the various Letters of Credit at different times over the past few years. The Banks did not have the same information at the time of each call.

[**175] Exhibits 1 through 6 are bound volumes of Exhibit Books containing all of the information which had been provided to the Banks prior to the first round of calls in November 1992. They consist primarily of documents and materials which pertain to allegations that were put forward on behalf of a large

number of Names (some also Respondents in these proceedings) in another action. That action, known as "the Ash action", was commenced in the Ontario Court of Justice (General Division) in September 1991. It sought declaratory and other relief and, in particular, claimed an interlocutory injunction restraining Lloyd's from calling upon certain letters of credit. The action failed in Ontario, because, on a counter [*70] notion, it was stayed on the ground that England and not Ontario was the forum conveniens for such an issue. The decision of Mr. Justice McKeown at first instance was upheld in the Court of Appeal, and leave to appeal to the Supreme Court of Canada was refused in October 1992. In early November, the first calls were made on the Letters of Credit in issue in these proceedings.

[**176] The "Ash action" materials were all provided to the Banks. They consisted of the amended Statement of Claim in that proceeding and the series of affidavits with exhibits which were presented as part of the injunction notion.

[**177] The lead affidavits in the Ash injunction proceedings were sworn on behalf of the many Names in that action by Jacqueline Levin, the Respondent in the Citibank Application in these proceedings. Her affidavits remain the foundational statement of the Respondents' position as advanced to the Banks in these proceedings.

[**178] Mrs. Levin described the history and structure of Lloyd's and the working of the Lloyd's insurance market, much as I have earlier related it, although in more detail. Her narrative included a recitation of the various scandals which had shaken [*71] Lloyd's in the 1970's and early 1980's, a reference to the several Commissions and Enquiries that had resulted from them, and the enactment of the new Lloyd's Act , 1982 which changed the governing structure of Lloyd's partially, at least, in response to them. Against this background, Mrs. Levin outlined the different areas of alleged fraud which I have described earlier, and which she portrayed as "Lloyd's discreditable conduct and Quasi Criminal conduct". It should be noted that these pre-November 1992 allegations did not include the "asbestos" allegations outlined above. The asbestos allegation assumed great significance in the next phase of the battle, which evolved after the first group of calls in November 1992, and occupied a great deal of time at the trial.

[**179] Mrs. Levin's affidavit relies heavily for the foregoing on the 200 page book entitled Lloyd's - A View of the Room: Change and Disclosure , written by Ian Hay Davison, the Chief Executive officer and a Deputy Chairman of Lloyd's from 1983 to 1986. The Book was given to the Banks. All parties appear to accept this work as an historical outline and description of Lloyd's and the Lloyd's insurance market and, [*72] indeed, of the circumstance existing in the Lloyd's market leading up to these proceedings – although the Banks do not necessarily accept all of Mr. Hay Davison's characterizations of the conduct he describes. They do accept the contents of the book as information provided to them and written by an informed and knowledgeable former "insider" at Lloyd's.

[**180] Mrs. Levin's affidavits in the Ash action were supported by the affidavits of two other Ash action plaintiffs -- Garnett Neil Webster and John Brian Webster -- who adopted her statements and who set the personal stage with respect to becoming a Member at Lloyd's; and by the affidavit of one Roy Charles Baker, a U.K. chartered accountant and Lloyd's broker and Name, who bolstered Mrs. Levin's claims concerning the impugned conduct of Lloyd's. Mrs. Levin was cross-examined. Numerous documents were marked as exhibits on that cross-examination.

[**181] The documentation which I have mentioned to this point constitutes four volumes of evidence, Exhibit Books I, II, III and IV.

[**182] The fifth volume, Exhibit Book V consists of the affidavit of Susan Kay Robinson, and exhibits, filed in the Ash action by Lloyd's and the [*73] Banks in support of the motion to stay that action. Ms. Robinson was an assistant solicitor employed by the Corporation of Lloyd's in London. The affidavit contained a flat statement "that Lloyd's deplores and emphatically denies the allegations of fraudulent conduct on its part." It also contained evidence pertaining to the contractual relationship between the Names and Lloyd's, including what transpires at "Rota" interviews with each Name prior to their joining Lloyd's, and documentation designed to rebut the serious allegation being advanced by the Ash plaintiffs concerning the removal of the approximate 24 million from the reserves of Feltrim Syndicates 540/542 without disclosing this to potential Names.

[**183] While most of the Robinson affidavit was struck out for purposes of the Ash stay proceedings – because Ms. Robinson did not attend for cross-examination, as I understand it -- its contents were all made available to the Banks as part of their deliberations respecting the "fraud" claim.

[**184] The sixth volume of materials presented to the Banks prior to the first calls on the Letters of Credit in November 1992 -- Exhibit Book VI -- consists primarily of affidavits [*74] attaching Press articles relating to the Ash action itself and various investigations concerning Lloyd's; of correspondence to the Banks from Mr. Lenczner on behalf of the Names, and from some Names themselves, forwarding newspaper clippings and other documentation in support of the Names' position that the Banks ought not to honour the Letters of Credit. Amongst this latter material were included,

[**185] a) the affidavit of Kenneth Randall, the former Head of Regulatory Services at Lloyd's, describing steps he had taken to investigate the involvement of certain Gooda Walker syndicates in the use of time and distance policies;

[**186] b) the judgment of the Honourable Mr. Justice Saville in the Boobyer action, dismissing an application by certain Names for an interim injunction restraining their respective members' agents from

giving the notices required in order to utilise the Names' personal reserves and their securities deposited at Lloyd's for the purpose of meeting unpaid cash calls;

[**187] c) the Report of Sir David Walker, dated June 1992, respecting "allegations that syndicate participations at Lloyd's were arranged to the benefit of working names and to the [*75] disadvantage of external names; and into the operation of the LMX spiral"; and,

[**188] d) a Report by T.R. Berry dated August 1992 respecting the management or Feltrim Syndicates 540/542 and 847.

The November 1992 Calls

[**189] The Banks who are Applicants in these proceedings were not persuaded that the information and materials contained in Exhibit Books I - VI were sufficient to establish clear or obvious fraud on the part of the Society or Council of Lloyd's. On November 6 and 9, 1992, they honoured the calls made on the Letters of Credit posted by the Respondents Peter Clarke and Murray O'Neil in favour of the Royal Bank of Canada, and by the Respondents Anne Hendrie, Ian Taylor and Edward Reynolds in favour of the Hongkong Bank of Canada.

The Post-November 1992 Calls and Further Materials Provided

[**190] The balance of the calls on the various Letters of Credits were scattered at intervals between April 15 and December 20, 1993. Specifically, calls were made on April 15 and 26, June 4, July 19, August 13 and 27, September 6, October 11 and 13, and concluded with the draw down on Mrs. Levin's Letter of Credit on December 20, 1993.

[**191] From time to time throughout [*76] this second period a further accumulation of documentation was forwarded to the Banks. It comprises an additional 6 volumes of evidence, Exhibit Books VII through XII. As well as continuing to pursue the earlier areas of complaint set out in the Ash action and developed by the Respondents' solicitors before the first series of calls, the information contained in these volumes embraced the allegations concerning asbestos.

[**192] The asbestos issue was first launched by Mr. Lenczner in a letter dated January 19, 1993 which was circulated to the Banks. It states, in part:

"Further to the previous letters and affidavits that we have provided to the Bank respecting the allegations of fraud against Lloyd's, we wish to advise that, most recently, a 1982 letter by Nevill and Russell has surfaced in which this firm of accountants warned the council members of Lloyd's that asbestos claims in the ensuing years would cause enormous losses at Lloyd's. It advised Lloyd's to ensure that proper reserves were taken by all the syndicates for this certain large exposure. [Emphasis start] There is no question but that Lloyd's failed to ensure that the syndicate members took appropriate reserves. [*77] Indeed. many of the council members of Lloyd's. who were underwriters themselves. dealt with the problem by recruiting new members to take on these future losses and by re-insuring those policies which contained such potential losses with other unsuspecting underwriters[Emphasis end]. [Emphasis start] In our view such conduct of Lloyd's constitutes a fraud and a cover-up. There was a total failure of appropriate disclosure. The members, including all the Canadian Names, were duped into becoming Names without being advised of certain past losses for which they would be responsible[Emphasis end]. Indeed, the Names were told of no unusual risks and were advised that the situation at Lloyd's was as it had been for 300 years. Ian Posgate, Roger Bradley, John Rew and many others have knowledge of and can substantiate these facts. There is significant documentary evidence to support these statements. We bring this to your attention and to the attention of the other Banks in Canada and to put you on notice of further significant allegations of fraud before you make any payout ... on behalf of anyone

(emphasis added)

[**193] The italicized portion of the foregoing letter succinctly [*78] states the position of the Respondents with respect to the asbestos issue. A series of letters from individual Names to the Banks setting out the same theme followed, some of them enclosing various newspaper clippings and some not.

The "Boswood Opinion"

[**194] Also included in the Exhibit Book VII materials was a legal opinion provided by a prominent London barrister, Mr. Anthony Boswood, Q.C., concerning Merrett Syndicate 418/417 - 1985 Year of Account. Although none of the Respondents underwrote insurance through this Syndicate, considerable emphasis was placed by them on Mr. Boswood's opinion, not -- as they put it in the standard letter which they forwarded to the Banks -- for his "opinion or conclusions on the points he analyzed", but for "his recital of a state of facts which existed in the Lloyds community in the late 1970's and early 1980's". Mr. Boswood had been asked by Names who had become members of Merrett Syndicate 418/417 for the first time for the 1984 and 1985 underwriting years of account, to give an opinion whether they had a claim for damages for negligence or other breach of duty arising from the closing into the 1984 or 1985 years of earlier years of account. [*79] He was asked to give that opinion with respect to potential claims against Merrett Underwriting Agency Management Limited -- the Managing Agent for the Syndicate -- and against the Members Agents who had placed them in the Syndicate, and against the Syndicate's auditors. On the basis of the facts as he outlined them, and analyzed them, Mr. Boswood was very firmly of the view that such claims could be successfully asserted. He did not say anything with respect to fraud. Nor did he say anything with respect to the Society or Council of Lloyd's.

The CIBC "Points of Defence"

[**195] Exhibit Book VII also contains a copy of "Points of Defence" raised by the Canadian Imperial Bank of Commerce in proceedings brought against it by the **Society of Lloyd's** in the High Court of Justice in England, seeking an order requiring CIBC to honour certain letters of credit. In that pleading, CIBC stated:

7. (a)The Defendant has been provided with information which its customers allege amounts to a sufficient case of fraud as to entitle the Defendant to decline to honour the drafts that have been presented ...

(b) The Defendant contends that the material provided was, to a reasonable banker in [*80] the position of the Defendant, sufficient to amount to notice of clear fraud by the Plaintiff. Further or alternatively, the material provided was such as would lead a reasonable banker in the position of the Defendant to infer fraud by the Plaintiff . Accordingly, the Defendant was entitled to dishonour the drafts and to decline to make any payment to the Plaintiff under the letters of credit.

(c) For the avoidance of doubt. the Defendant does not allege fraud against the Plaintiff .

(underlining added)

[**196] This pleading is apparently similar to ones filed by other Canadian Banks in similar U.K. proceedings. The Respondents submitted to the Applicant Banks in these proceedings that the U.K. pleading constituted an admission on the part of the other Canadian Banks that clear or obvious fraud had been established. It constituted no such admission, however, in my view. It was simply a pleading and an attempt to set up a "reasonable banker" defence. "Fraud" was specifically not alleged against the **Society of Lloyd's.** In any event, Mr. Justice Saville in the U.K. Court struck out the pleading, giving CIBC leave to amend to allege fraud directly against the Society. The [*81] Bank declined to do so, and judgment was subsequently granted against it in favour of the Society requiring CIBC to pay on the letters of credit.

"Further Notice to the Banks of Fraud"

[**197] On September 22, 1993, the Applicant Banks were provided with two further volumes of documents entitled "Further Notice to Banks of Fraud" -- Exhibit Books VIII and IX. At that point draws remained to be made on the Letters of Credit of the Respondents Peter Palmer, Sean McDonough, Hugh Hendrie, Jane and William Perrin (one of two calls for each of them) and Mrs. Levin.

[**198] Volume VIII contains a number of Reports, memoranda and correspondence pertaining to the asbestos allegations made by the Names -- in particular, a Lloyd's memo to underwriters and agents in 1980 setting up an "Asbestos Working Party"; the Neville Russell letter of February 24, 1982 on behalf of the Lloyd's panel auditors; the Murray Lawrence response of 18th March 1982, sent also to active underwriters and underwriting agents; an unsigned statement purportedly made by Stephen Murray Mitchell, a senior solicitor who represented the Asbestos Working Party (to which Mr. McNish of the Royal Bank of Canada said he [*82] gave little weight because it was unsigned, but which the other bankers who made the decision to honour the Letters of Credit said they took at face value); a formal Report by Kenneth Randall (through his company) respecting the Gooda Walker Time and Distance Policy program; and a Report by Sir Patrick Neill (or, at least parts of it) which had been prepared in September 1992 and which concerned the losses sustained by the Feltrim Syndicates 540/542 and 847 and the LMX Spiral.

[**199] Exhibit Book IX is a rather disorganized and not always clearly identified collection of excerpts from Reports, correspondence and articles dealing with various problems and losses at Lloyd's. Exhibit Books X through XII consist of more newspaper articles, correspondence and Reports of various kinds on various subjects pertaining to the alleged fraud.

"The Longtail Chairman's Report"

[**200] Of some note amongst these latter materials is the Report of a group known as the "Long Tail Chairmen's Group". It is relied upon by the Respondents for its reference to certain members of the Asbestos Working Party including Mr. Murray Lawrence, the Deputy Chairman of Lloyd's having arranged whole account [*83] run- off reinsurance for their own syndicates, thus protecting themselves from future asbestos losses, just before the March 18, 1982 letter from Mr. Lawrence to the active underwriters and underwriting agents advising of the pending peril. The Respondents submit this is further evidence of fraudulent non- disclosure. The Applicant Banks submit that it is nothing of the sort, but in any event assert that the mere reference in such a Report is not proof of the fact that such an event occurred.

The Kenneth Randall Statement

[**201] Also of note in the Exhibit Book XII materials is the Statement of Kenneth Randall to which I have earlier alluded (the "Randall Statement", as opposed to the Randall "Affidavit") and which comments upon the Neville Russell letter of February 1982 and events arising subsequently in relation to it. Mr. Randall's Statement in respect of the Neville Russell letter and the March 18, 1982 response of Mr. Lawrence is relied upon by the Respondents as highlighting the grave severity of the asbestos problem and the need for syndicates either to leave their 1979 years of account open or to take 'such large provisions for future asbestos claims that the market [*84] would effectively be bankrupt". Mr. Randall stated that he "fully expected that many syndicates would take the decision to leave their 1979 year open and that others would report substantial losses". He was "surprised that this prediction was not fulfilled", and drawn to the conclusion, as a result, "that many syndicates failed to comply with

Lloyd's instructions". Given the regulatory authority of the Council of Lloyd's, and through it of the **Society of Lloyd's,** the Respondents submit that Lloyd's must have known this failure was occurring and that they fraudulently failed to disclose such a state of affairs to new underwriting Names.

[**202] Thus, there were documents and materials forwarded to the Banks in support of the fraud defence which fill 12 volumes of evidence. Each volume contains between 250 and 350 pages or more. When placed in one pile, Exhibit Books I through XII measure over 16 inches in thickness, by my calculations.

E. HOW THE BANKS RESPONDED

[**203] For the most part, the bankers who examined the information and materials put forward by the Names accepted that information and materials at face value. They did not seek to discount what was contained in them. [*85] They each concluded, however, that the information and materials were insufficient to establish clear or obvious fraud on the part of the Society or Council of Lloyd's.

The Hongkong Bank of Canada

[**204] Mr. David Hunter and Mr. L.Y. Wickremeratne examined the documentation on behalf of the Hongkong Bank of Canada and the Hongkong and Shanghai Banking Corporation, respectively. The Hongkong and Shanghai Banking Corporation was the confirming Bank in London, England, which was called upon by Lloyd's to make the payments on the Letters of Credit; it then sought and obtained reimbursement from its issuing Bank, the Hongkong Bank of Canada, which is thus the Applicant in the proceedings.

[**205] Mr. Hunter is the Assistant Vice President Trade Services, for the Hongkong Bank of Canada. He has had extensive experience, training and involvement with letters of credit in international transactions, and his current responsibilities include that area, together with broader services of the Bank. He has participated both as a presenter and co-chair of local and global conferences respecting letters of credit in recent years. He was asked by Mr. David Sargeant, the Bank's Assistant Vice [*86] President, Special Credit -- who was responsible for determining whether letters of credit would be honoured -- to review the documents under the supervision of Mr. Casey, and to advise whether the banker's test of clear or obvious fraud had been met.

[**206] In this connection Mr. Hunter was provided with a definition of civil fraud by Mr. Casey, counsel for the Banks. He reviewed the documents in light of that definition and test, making notes as necessary and occasionally making queries of Mr. Casey. He considered, initially, the contents of what are now Exhibit Books I through VI -- the documentation provided by the Names before the first round of calls in November 1992 -- over four separate occasions and a period of approximately 14 hours in total. Having done this, Mr. Hunter came to the conclusion that while there were numerous allegations of fraud on the part of the Names, and while there had been a number of independent investigations of Lloyd's and there were substantial criticisms of practices in the Lloyd's market, there was not sufficient evidence of clear or obvious fraud in connection with the relationship between the customers and the Society or Council of Lloyd's [*87] to meet the test. He so advised Mr. Sargeant.

[**207] As subsequent calls were made, and more information was tendered by the Names, Mr. Hunter conducted similar examinations, and came to the same conclusion.

[**208] Mr. Hunter stated that he did not discuss his review with anyone else at the Bank. He acknowledged that he did not make any other outside enquiries of experts in the insurance industry or contact the people mentioned in Mr. Lenczner's correspondence as being available; and he did not contact the Names whose Letters of Credit were being called upon to seek explanations or clarification. During a vigorous cross-examination, he agreed that some of the conduct to which he had been referred "could" be fraud, including fraud in the sense of reckless disregard for the truth of what was at issue, but maintained his view that that same conduct might also have amounted to incompetence or negligence. He pointed to the evidence in certain places in the materials, such as the Walker Report, which concluded that there was no deliberate intent on the part of Lloyd's to defraud its Names and no fraud with respect to the LMX Spiral.

[**209] Mr. Wickremeratne is Manager Services [*88] at the Hongkong and Shanghai Banking Corporation in London, England. He has 40 years of experience with the Bank at various places around the world, and his experience, too, includes extensive involvement with letters of credit.

[**210] It was Mr. Wickremeratne's role in London to ensure that he and the operational staff examined the presentations under each Letter of Credit to see that they conformed to the terms of the credit. He was also requested by the Bank's legal department to examine the materials which the Hongkong Bank of Canada had received and to assist in advising whether, in his view, the fraud test had been met. His guidance in this latter regard came in the form of an internal memorandum from the legal department outlining the applicable law, including a similar definition of fraud to that which had been provided to Mr. Hunter and a summary of some factors to consider in applying the test in question.

[**211] Mr. Wickremeratne arrived at the same conclusion as had Mr. Hunter and authorised payment on the various Letters of Credit. He did so, similarly, without making any outside enquiries of experts or others, and without contacting any of the Bank's customers [*89] (or their solicitors) for clarification.

[**212] As the way in which the Banks approached the exercise of determining whether there was clear or obvious fraud was strongly attacked at trial by the Respondents -- both for the failure to make outside enquiries and for the alleged failure to give adequate weight to the concept of recklessness in the

definition of fraud -- it is important to note the parameters that Messrs. Hunter and Wickremeratne were given.

[**213] Exhibit 25 is a full page definition of fraud which was furnished to Mr. Hunter (and also to Mr. Chen of Citibank) by Mr. Casey. In my view it is an accurate statement of the concept, and Mr. Lenczner did not submit otherwise. Much of the exhibit is taken up with an excerpt from Halsbury's Laws of England , Volume 31 (paras. 1059, 1061 and 1065), but the substance of the concept is summarized at the beginning and the end of the document as follows:

A fraudulent misrepresentation is a false representation made with the knowledge that it is false, or without an honest belief in its truth, [Emphasis start] or recklessly without caring whether it is true or false.[Emphasis end] A false statement made through carelessness [*90] and without reasonable grounds for believing it to be true is not fraudulent if made in the honest, although careless, belief that it is true. Negligence, carelessness and wishful thinking in making a representation are not enough to establish fraud.

...

The test for fraudulent misrepresentation thus comes down to an absence of actual and honest belief in the truthfulness of a statement.

(emphasis added)

[**214] The advice which Mr. Wickremeratne received from Mr. Walton, Assistant Legal Advisor Europe, was the following (as excerpted from Exhibit 37):

The Applicable Law

As you are aware, LCs are autonomous documents and a bank including a confirming bank, is required to honour [a] call made under the LC if documents of demand presented to it under the LC are strictly in accordance with the requirements of the LC.

The only exception to this overriding legal and commercial principal [sic] is where the bank is in possession of knowledge of clear and obvious fraud on the part of the beneficiary . .... In essence, this requires a determination as to whether a clear and obvious fraud in relation to the transactions underlying the LCs has been established to the Bank [*91] prior to its making payment under the LCs. The transactions underlying these LCs are the manner in which the names have incurred their liabilities to Lloyds.

Clear and Obvious Fraud

The concept of clear and obvious fraud is relatively undefined under English law. Dictionary definitions of "clear" and "obvious" are of some help:

" clear " - unambiguous, easily understood - manifest, not confused or doubtful,

" obvious " - easily seen or recognised or understood, palpable, undubitable [sic].

The following points can however be distilled from what existing case law there is.

1.Evidence of fraud must be clear and plain.

2.If the evidence is confused, conflicting or indeed ambiguous as to whether there is fraud, then the fraud exception will not be made out.

3.Uncorroborated assertions or statements by a Name are not enough.

4.Strong corroborative evidence of the allegations in the form of contemporary documents is necessary.

5.The conclusion of fraud must be plain . If there is conflicting yet seemingly reliable evidence the fraud exception will not be made out.

6.Also, there must have been an opportunity to answer allegations (in this case on the part of Lloyds) [*92] and a failure to provide any adequate answer in circumstances where one could be expected.

7.Bankers will not be imputed with any special knowledge or expertise on the workings of Lloyds and must simply make their determination as best they can on the evidence before them. Bankers will not be required to undertake the role of amateur investigator.

Your will also need to know what constitutes fraud. Fraud under English law derives from the case of Derry v Peek , where it was stated that fraud is proved where it is shown that a false representation has been made knowingly, or without belief in its truth, or recklessly, without caring whether it is true or false . An intention to deceive or the reckless disregard of the truth is critical here. It is insufficient to establish a misrepresentation or indeed mere negligence alone. in relation to Lloyds, this will therefore need to show not that Lloyds were not simply negligent in the way they carried on their business, but they knowingly made false representations to the Names.

(underlining in original; italics added)

[**215] Both Mr. Hunter and Mr. Wickremeratne made their decisions against the background of the foregoing [*93] legal advice with which they had been provided. That advice, I am satisfied, was accurate and quite adequate for their purposes.

The Royal Bank of Canada

[**216] George Alan McNish, Royal Bank's Vice President International Trade, Ontario, was responsible for deciding whether his Bank would honour the Letters of Credit. Mr. McNish has been with the Royal Bank for 28 years, the last 5 1/2 of which have been in his current position where he is responsible for the Bank's international trade centre in Toronto. His responsibilities include the issuing of letters of credit and advising with respect to them.

[**217] Like Messrs. Hunter and Wickremeratne, Mr. McNish initially examined the materials filed in connection with the Ash action -- Exhibit Books I through VI -- and subsequently, after the first round of calls in November 1992, he examined additional materials as they were presented by the Respondents or their counsel. It took him many hours over several days to read the materials in the Ash action. He looked for evidence of fraud and also for material that would in total corroborate the statements made with respect to the allegations. Unlike Messrs. Hunter and Wickremeratne, [*94] Mr. McNish was not provided with a legal definition of fraud. Rather, he worked on the basis of his own definition of fraud which was that there should be shown a deliberate misrepresentation or distortion or concealment of the truth for gain. Although it might have been wise, in the circumstances, for Mr. McNish to seek legal advice on the meaning of "fraud" in the context, I am satisfied that the layperson's rule of thumb approach which he utilised captured the essence of the notion. I do note that it lacks the element of recklessness which is a part of the traditional definition as articulated in Derry v. Peek , the authority mentioned in the opinion provided to Mr. Wickremeratne and the basic authority for the fraud concept in Anglo-Canadian jurisprudence.

[**218] Mr. McNish concluded, after reviewing all of the materials, that there was not sufficient evidence of clear or obvious fraud to justify the Bank in declining to honour the Letters of Credit. In coming to this conclusion he was influenced by the "rebuttal" allegations contained in the Susan Robinson affidavit filed in the Ash action on behalf of Lloyd's, by the statement in the Walker Report that its Committee had [*95] formed no view there had been fraud in connection with the LMX Spiral, and by reports in the Press that Sir Patrick Neill's findings confirmed the Walker Report with regard to the LMX Spiral. Mr. McNish was also influenced by the decision of Saville J. in England striking out the "reasonable bankers pleading in actions against other Banks; from this he deduced that it would be necessary for his Bank to prove fraud if sued by Lloyd's in the U.K. for dishonouring the Letters of Credit, and he felt that the Bank could not meet that onus on the basis of the materials that had been provided to him. He drew a distinction -- correctly, I think -- between the Society and the Council of Lloyd's (to whom the "fraud" must be brought home) and other participants in the Lloyd's market, such as brokers, active underwriters and managing agents.

[**219] Like his colleagues at the other Banks, Mr. McNish did not go beyond the materials provided to him and contact either experts in the insurance industry for advice or the Bank's customers for clarification. He acknowledged that he was influenced to a certain extent, in coming to his decision, by the possible negative impact on the Bank's international [*96] reputation if it were to dishonour the Letters of Credit.

Citibank

[**220] Joseph Chen made the decision on behalf of Citibank to honour the Letter of Credit which had been issued at Mrs. Levin's request. He has been Vice President Credit for Consumer Banking at Citibank since 1992 and has been with Citibank since April 1986. As he assumed his new position in June 1992, he inherited the responsibility for supervising the Ash action situation from the Bank's perspective. He reviewed the materials which had been provided to the Bank in order to determine whether they established clear or obvious fraud on the part of Lloyd's. It took him roughly two weeks to do so, he testified -- the first week of which he was virtually "locked in a room". At the end of the exercise he concluded that, while there appeared to be a lot of managing agents and underwriters who had been conducting business in the Lloyd's market in a manner that was below standards -- negligently or with improper bookkeeping methods he could not persuade himself that what he had been shown constituted evidence of clear or obvious fraud. The Bank honoured the call on Mrs. Levin's Letter of Credit.

[**221] Mr. Chen, [*97] as I have noted, had been provided by Mr. Casey with the same definition of fraud as had been given to Mr. Hunter, and portions of which are outlined above.

F. WHAT THE EXPERTS SAID REGARDING "FRAUD"

[**222] Both the Applicants and the Respondents called expert evidence on the issue of whether the documentation and materials provided to the Banks, in their view, were sufficient to establish "clear or obvious fraud".

Michael Bergin

[**223] Michael Bergin, a retired banker, was called on behalf of the Banks, and qualified to give expert evidence regarding banking practice with respect to international letters of credit. Mr. Bergin had been 41 years with Barclays Bank in England, much of that time with the Bank's international division specializing in documentary letters of credit and bank guarantees. He has played a special role as worldwide advisor for Barclays respecting standby and documentary letters of credit. He has also provided such advice in connection with the British Bankers' Association and the International Chamber of Commerce.

[**224] Mr. Bergin was asked to review the documentation which had been presented to the Banks by and on behalf of the Respondents and [*98] to give his opinion, as an experienced banker, as to what he would have done in the circumstances. He spent 50 to 60 hours reviewing the papers. It was Mr. Bergin's opinion that the papers presented did not contain any evidence of fraud on the part of the Society or Council of Lloyd's either with respect to asbestos, Time and Distance Policies, the LMX Spiral or overwriting. He would have felt obliged to honour the Letters of Credit, he stated.

[**225] There was an issue at trial as to whether Mr. Bergin had actually reviewed the papers and materials relating to the underlying transaction, or whether he had confined himself to a review of the documents presented by Lloyd's on the call of the Letters of Credit. On an earlier cross-examination in London Mr. Bergin had stated to Mr. Lenczner that he had not made any inquiry into the underlying transaction, but had confined himself to the documents presented. At trial, Mr. Bergin explained that he had misunderstood Mr. Lencnzer's line of questioning, because the word "documents" to a banker refers to "documentary compliance" whereas the other materials presented are thought of as "papers". He had thought Mr. Lenczner was referring [*99] to the former. Notwithstanding Mr. Lenczner's vigorous cross- examination on this subject, I accept Mr. Bergin's testimony at trial that he indeed did examine all of the papers and materials presented. He simply did not strike me in the least as a person who would deliberately lie. I accept his evidence.

Brian White

[**226] Mr. Brian white was called, and qualified, to give expert evidence on behalf of the Respondents with respect to when a bank must honour, and when a bank must decline to honour, letters of credit. Mr. White's credentials are impressive, as well. Presently a self-employed banking consultant, he worked for 30 years with Lloyd's Bank in England. He was asked to, and did, review the contents of Exhibit Books I through XII (the sum of the documentation and information presented by or on behalf of the Respondents to the Banks) and to advise whether a reasonable banker with that information would accept or decline the calls on the Letters of Credit on the basis of established or lack of clear or obvious fraud.

[**227] Mr. White came to the conclusion, after reviewing the materials for some time, that there was evidence of clear or obvious fraud.

[**228] He looked [*100] particularly, in this respect, at the issues of asbestos, time and distance policies and the LMX Spiral. It was his opinion that the materials taken by themselves established clear and obvious fraud with respect to the asbestos allegations, and that cumulatively the allegations concerning asbestosis, time and distance policies and the LMX spiral did so. Taken separately, he conceded in cross-examination, the materials pertaining to time and distance policies and the LMX Spiral, only amounted to a strong prima facie case, in his view.

[**229] Mr. White agreed that the allegations being put forward regarding Lloyd's failure to disclose potential asbestos liabilities and Lloyd's failure to regulate the market with respect to time and distance policies and the LMX Spiral could be characterized as negligence, or incompetence or fraud. It was his opinion, however, that they constituted fraud. He agreed that reasonable bankers could differ in arriving at these conclusions -- "no doubt", as he put it, "some others reviewing the same materials could have come to a different conclusion".

Other Experts

[**230] Three other experts testified on behalf of the Respondents, with a view to [*101] establishing that Lloyd's failed in disclosing to prospective Names the extent of potential asbestos claims; that Lloyd's failed in carrying out its regulatory functions by not ensuring that syndicates took adequate reserves for asbestos; and that these failures amounted to "recklessness" -- and, therefore, "fraud" on the part of the Society and Council of Lloyd's.

[**231] The witnesses who testified in this regard were Mr. John Rew, the editor of the Chatset Lead Tables, an annual publication analysing the accounts of Lloyd's syndicates; Mr. Newton Keene Grant, a prominent British accountant who gave evidence with respect to the requirements for corporate disclosure in financial statements; and Ian Richard Posgate, a well-known Lloyd's underwriting and managing agent. The evidence of these witnesses has been reviewed in the earlier section of these Reasons dealing with the asbestos issues, and I will not repeat that review here.

PART III

LAW AND ANALYSIS

[**232] The somewhat lengthy elaboration of the facts in the previous Part has been necessary, in my view, to provide not only an outline of the "Lloyd's context" in which these proceedings are grounded, but also to provide [*102] some understanding of the wealth of information and materials which the Respondent Names were able to furnish to the Banks and of the nature and complexity of that information and material.

[**233] I turn now to the law respecting the defence of "fraud" in letter of credit transactions, analyzed against the backdrop of those facts.

[**234] In my view, the "fraud" defence put forward by the Respondents cannot succeed. Whatever may be the equities between the Names and the Society and Council of Lloyd's, they do not constitute clear or obvious fraud established to the knowledge of the applicant Banks. The Banks, thus, were entitled -- indeed, obliged -- on this basis, to conclude that they were required to honour the Letters of Credit presented for payment.

A. THE PRINCIPLE OF AUTONOMY OF LETTERS OF CREDIT

[**235] The central characteristic of a letter of credit transaction is its autonomous nature. Letters of credit are completely autonomous from and independent of the underlying transaction which exists between the person at whose instance the credit is issued and the beneficiary of the credit. They constitute a separate contract between the issuing Bank and the beneficiary. [*103] The rationale behind this concept is based on the view, as expressed by several courts, that such irrevocable

obligations on the part of banks "are the lifeblood of international commerce": see R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd. [1977] 2 All E.R. 862, per Kerr J. at p. 870; adopted by Lord Denning M.R. in Edward Owen Engineering Ltd. v. Barclays Bank International Ltd. [1978] 1 Q.B. 159, at p.171; see also, United Trading Corporation S.A. v. Allied Arab Bank Ltd. [1985] 2 Lloyd's Law Reports 554, at p. 558 (C.A.); and Westpac Banking Corporation v. The Duke Group Limited et al., (1994) 20 O.R. (3d) 515, at pp. 522-529 (Ont. C.J., Gen.Div.).

[**236] In Angelica-Whitewear , supra , LeDain J. stated (at p. 70): The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit [*104] is independent of the performance of the underlying contract for which the credit was issued. Disputes between the parties to the underlying contract concerning its performance cannot as a general rule justify a refusal by an issuing bank to honour a draft which is accompanied by apparently conforming documents. This principle is referred to as the autonomy of documentary credits.

[**237] Mr. Justice LeDain continued by noting that this principle is reflected in the provisions of the Uniform Customs and Practice for Documentary Credits. Identical provisions to those cited by the Court are to be found in the 1983 version (UCP No. 400) to which the Letters of Credit in these proceedings are expressly made subject, at the following Articles:

Article 3

Credits, by their nature, are separate transactions from the sales or other contracts on which they may be based and banks are in no way concerned with or bound by such contracts), even if any reference whatsoever to such contracts) is included in the credit.

(italics added)

Article 4

In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents [*105] may relate

(italics added)

[**238] Farley J. emphasized the importance of preserving the integrity of the letter of credit process in the following passage from his judgment in Westpac Banking Corp. v. The Duke Group , supra , at p. 523: It is well-established that a letter of credit is an independent obligation. The issuer bank agrees to pay to the beneficiary upon the satisfaction of the conditions contained in the letter of credit itself (e.g. , the presentation of the appropriate documents). This rule is quite necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. That is, it is clear that the conventions of letters of credit must be strictly adhered to and interpreted for the overall policy reason of maintaining this quite valuable facility on an overall basis : see the Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce Publication No. 400 ("UCP") (note this revision is stated at p. 6 to take into account the "development of new types of documentary credits, such as the deferred payment credit and the stand-by-credit").

[**239] The rigours of this doctrine [*106] make the letter of credit a particularly unforgiving financial instrument for those who choose to use it as a method of providing security for their obligations. A letter of credit utilised for these purposes is known as a "standby letter of credit", presumably because it "stands by" in the event of a default on the part of the party at whose instance it has been issued in carrying out its obligations towards the beneficiary of the credit. Frequently a standby letter of credit can be called upon by the beneficiary, however, simply upon the presentation to the bank of a sight draft reciting the necessary information set out in the terms of the credit. it requires no proof of loss on the part of the beneficiary, and does not involve the presentation of other documentation emanating from third parties -- such as is the case with documentary credits securing sale of goods transactions in which bills of lading and insurance documents are customarily required.

[**240] In short, the consequences of a call on a standby letter of credit -- such as those provided by the Respondents to the Society and Council of Lloyd's -- can be harsh, draconian and abrupt.

B. THE "FRAUD" EXCEPTION

[**241] [*107] Provided the documentation presented is in compliance with the terms of the credit, there is only one escape from the principle of autonomy in letter of credit transactions. That exception is "fraud".

[**242] In Angelica-Whitewear , supra , the Supreme Court of Canada "affirm[ed] the fraud exception to the autonomy of documentary letters of credit as part of Canadian lawn (p. 81). At pp. 71- 72, Mr. Justice LeDain, on behalf of the Court, stated: An exception to the general rule that an issuing bank is obliged to honour a draft under a documentary credit when the tendered documents appear on their face to be regular and in conformity with the terms and conditions of the credit has been recognized for the case of fraud by the beneficiary of the credit which has been sufficiently brought to the knowledge of the bank before payment of the draft or demonstrated to a court called on by the customer of the bank to issue an interlocutory injunction to restrain the bank from honouring the draft.

...

... Differences of view or emphasis with respect to these issues (a discussion of questions concerning the scope and availability in practice of the fraud exception had preceded (sic) [*108] this section),

particularly the kind of fraud and proof required, reflect the tension between the two principal policy considerations: the importance to international commerce of maintaining the principle of the autonomy of documentary credits and the limited role of an issuing bank in the application of that principle; and the importance of discouraging or suppressing fraud in letter of credit transactions. The potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.

[**243] And at p. 83: In my opinion the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such a character as to make the demand for payment under the credit a fraudulent one. .... [Emphasis start] In my view the fraud exception ... should extend to any act of the beneficiary of a credit the effect of which would be to permit the beneficiary [*109] to obtain the benefit of the credit as a result of fraud[Emphasis end].

(emphasis added)

C. THE LEGAL TEST OR PRINCIPLE

[**244] As I noted earlier in these Reasons, the "fraud" defence in these proceedings raises issues relating more to the question of how the test is to be applied than to the question of what the test is in the circumstances. The test in cases where no order has been sought from the court and where "the issuing bank has had to exercise its own Judgment as to whether or not to honour a draft", has been stated with simple clarity by the Supreme Court in the foregoing passage from the judgment of LeDain J. in Angelica Whitewear , supra , at p. 84:

... the test in my opinion should be the one laid down in Edward Owen Engineering -- whether fraud was so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank.

D. ISSUES ARISING ON TEE APPLICATION OF THE LEGAL TEST

(a) The Banker's Test

[**245] What is the duty cast upon a banker presented with materials and information which the customer asserts establishes clear or obvious fraud on the part of the beneficiary of the letter [*110] of credit ? Is the measuring stick by which the performance of that duty is to be assessed an objective one, i.e., is it the test of "the reasonable banker"; or is the performance of the duty to be measured by some other parameter ? Does the banker have an obligation to make independent inquiries beyond the information and materials provided by the customer ?

[**246] These questions raise difficult practical concerns for the bankers, for in the performance of this exercise, it seems to me, they operate under two major disabilities. In the first place they are neither lawyers nor judge. In the second place, they are not experts in the particular field of commerce or business which is the subject of the underlying transaction. With respect to this latter difficulty, and in the context of these particular proceedings, they are not insurers; and the world insurance market, which provides the setting for the underlying transactions here, is extremely complex and sophisticated.

[**247] Although the bankers have professional advice available to them in both the legal and insurance fields, they are ill-equipped as bankers -- and it is their function as bankers which is at issue here [*111] -- to carry out the task ascribed to them by the Supreme Court of Canada in Angelica Whitewear and by the English Court of Appeal in Edwards Owens Engineering . It is for these reasons, I am sure, that both of those Courts have placed the standard of convincing so high.

[**248] For "fraud", although an easy word to say, is a concept that is not always easy to apply. And the world insurance market, as I have observed, is very complex. To ask bankers to make a determination that fraud has been established in a fashion that is "clear or obvious" in such a context, is to assign them a difficult task -- one for which, as I have said, they are not well equipped.

[**249] This can cut both ways, however, and raises two further questions. Does it follow that bankers can take a more laissez-faire approach and allow themselves to be persuaded more easily that fraud has not been "established" with the required clarity ? or, does it mean that the banker's obligations are even more onerous, and that, in such circumstances, in order to protect the interests of their customers, as well as to ensure that they are meeting their obligations to the beneficiary contracting party, that they [*112] must dig deeper and make extra enquiries and that, as Mr. Lenczner submitted, the test should be applied in a more elastic fashion (my words) in recognition that fraud may be more difficult for the customer to establish in such circumstances ?

(i) The Standard

[**250] In my opinion, the standard by which the banker's duty is to be assessed in these circumstances is not the objective one of a reasonable banker, i.e. it is not a question of whether the material provided by the Respondents would either amount to notice to a reasonable banker of clear fraud by the beneficiary or would lead a reasonable banker to infer fraud by the beneficiary. Mr. Justice Saville rejected such a test in The **Society of Lloyd's** v. Canadian Imperial Bank of Commerce and Others (1993), Folio Nos. 112-116 (Eng. H.C.J.), and I agree.

[**251] Saville J. pointed out the clear difficulties with such a standard in the following passage from page 2 of his decision: ... the suggested defence would, on the face of it, produce absurd or unacceptable results. If the defence is a good one and the court was persuaded at trial that the material provided to the Bank did amount to clear notice of fraud to a reasonable [*113] banker etc, then the

Bank would be under no obligation to pay even if at the same trial the beneficiary were able to establish that in truth (notwithstanding the apparently damning material) there was no fraud. This cannot possibly be right. Alternatively, if proof of no fraud in fact would be an answer to the defence, the effect of the defence would be to cast the burden of proving the absence of fraud upon the beneficiary. That in turn would involve the proposition that the Bank is under no obligation to pay on genuine documents unless and until the beneficiary proves that they are genuine. This again cannot possibly be right and as Mr. Ruttle for the Plaintiffs pointed out would be entirely inconsistent with the fraud provisions of the Uniform Customs and Practise for Documentary Credits, which were incorporated into the Letters of Credit in this case.

[**252] While a banker must act "reasonably", in my opinion, in the sense of acting honestly and in good faith in his or her capacity as a banker , the question is not whether the banker concluded, as a reasonable banker would have done, that fraud had been clearly or obviously established. To import such a test would be to [*114] turn the exercise into a battle of experts, involving lengthy debate and the weighing of differing views by the banker, and ultimately involving trials such as this one. More to the point, it would be to transform the function of the banker into that of a lawyer or, more problematically, into that of a judge. I would be reluctant to conclude that either the Supreme Court of Canada, in Angelica , or the English Court of Appeal, in Edward Owen Engineering , intended such a result.

[**253] The very difficult position of a banker in such a situation was alluded to by Mr. Justice LeDain in Angelica , at p. 84, where, in laying down the test and drawing a distinction between cases where an interlocutory injunction is sought and those where the bank must exercise its own judgment he said:

"... I would draw a distinction between what must be shown on an application for an interlocutory injunction to restrain payment under a letter of credit on the ground of fraud by the beneficiary of the credit and what must be shown, in a case such as this one, to establish that a draft was improperly paid by the issuing bank after notice of alleged fraud by the beneficiary. A strong prima facie [*115] case of fraud would appear to be a sufficient test on an application for an interlocutory injunction. Where, however, no such application was made and the issuing bank has had to exercise its own judgment as to whether or not to honour a draft, the test in my opinion should be the one laid down in Edward Owen Engineering -- whether fraud was so established to the knowledge of the issuing bank before payment of the draft as to make the fraud clear or obvious to the bank. The justification for this distinction, in my view, is the difficulty of the position of the issuing bank, in so far as fraud is concerned , by comparison with that of a court on an application for an interlocutory injunction. In view of the strict obligation of the issuing bank to honour a draft that is accompanied by apparently conforming documents, the fact that the decision as to whether or not to pay must as a general rule be made fairly promptly, and the difficulty in many cases of forming an opinion, on which one would hazard a lawsuit , as to whether there has been fraud by the beneficiary of the credit, it would in my view be unfair and unreasonable to require anything less of the customer in the way [*116] of demonstration of an alleged fraud."

(underlining added)

[**254] It is, after all, fraud which must be established and made clear or obvious to the bank, not the appearance of fraud to a reasonable banker . It is evidence of fraud, as LeDain J. observed in the passage above, "on which one would hazard a lawsuit", that must form the basis for the decision not to honour the letter of credit: see also, The **Society of Lloyd's** v. CIBC , supra , at p. 4.

(ii) Is There a Duty to make outside Enquiries?

[**255] The Respondents submitted, in addition, that the Banks failed to meet the requisite standard, in the present circumstances, because they made no enquiries beyond the documentation and materials provided to them. They did not consult with experts in the insurance business. They did not seek further clarification or information from their customers, the Respondent Names. They did not avail themselves of the opportunity to speak with persons such as Mr. Rew or Mr. Posgate, whose names – along with others -- had been given to them by the Names as persons who could provide additional information. Both Mr. Rew and Mr. Posgate testified that they would have been available [*117] to speak with the Banks had they been contacted, but that they were not contacted. At the same time, they indicated that they would have been available to provide a statement or affidavit to the Respondents for the purposes of informing the Banks, but were not asked to do this either.

[**256] I am satisfied that the Banks had no obligation, in the circumstances of this case, to make such further enquiries. Generally, there is no such duty in letter of credit situations. This, too, was made clear by the Supreme Court of Canada in Angelica-Whitewear , supra , at p. 88, where LeDain J. stated:

... It is important to bear in mind that an issuing bank does not, as a general rule, have a duty to satisfy itself by independent inquiry that there has not been fraud by the beneficiary of a credit when it is presented with documents that appear on their face to be regular. It is only when fraud appears on the face of the documents or when fraud has been brought to its attention by its customer or some other interested party that it must decide whether fraud has been so established as to require it to refuse payment.

[**257] That is not to say that there could never be circumstances [*118] in which a banker is called upon to make further inquiries. if, for instance, the materials given to a Bank contained some obvious gap that appeared explicable, but otherwise cried out with the word "fraud", it might be incumbent upon the recipient Bank to seek clarification from its customer or elsewhere. No such situation existed here, however. Although the Respondents requested the Banks to ask for any further materials which they

thought might be missing and invited them to speak with people in the industry, a banker -- who generally must respond reasonably quickly to the demand for payment under the letter of credit -- need not parse the materials tendered with a fine toothed comb to ensure that absolutely every reference contained therein has been provided; nor is he or she obliged to consult with outsiders, at least when there is little to suggest that the outsiders will have anything new to contribute. Messrs. Rew, Posgate and others were simply put forward as people who "had knowledge of and could substantiate these facts" (letter of Mr. Lenczner dated January 19, 1993, cited above), that is, the facts already put forward by the Names. If those facts themselves did not signal [*119] "clear or obvious fraud" to the Banks – as they did not -- their substantiation from other sources could not elevate the Respondents' position.

[**258] Neither the evidence of Mr. Rew nor that of Mr. Posgate, when given at trial, was sufficient to establish any fraud on the part of anyone. Indeed, the evidence of Mr. Posgate on the question of how his Syndicates (and by inference others with whom he spoke) chose to cope with the asbestos crisis by spreading the reserves over future years -- "doing it gently over 10 years", as he put it -- in the belief at the time that is was equitable and prudent to do so , suggests the contrary. If leading underwriters in the Lloyd's market were following such a path, believing it at the time to be the equitable and prudent one – even though in hindsight it has turned out not to be so -- how can the Society or Council of Lloyd's, as the regulator of that market, be viewed as being clearly or obviously dishonest, deceitful or reckless in failing to ensure that something else was done ? In my view, they could not be, and there was no duty on the part of the Banks to embark upon enquiries beyond a careful examination of the voluminous materials [*120] provided, acting honestly and in good faith in their capacity as bankers in doing so.

[**259] Although Mr. White, the Respondents' expert witness, indicated that he might make enquiries of the customer if need be -- he did not think it necessary to go beyond the materials provided to him in this case, however -- he acknowledged that the Banks had no obligation, as he expressed it, "to send a half dozen of its trusted servants to search the woods to turn up truffles". He agreed, in cross-examination, that if a customer makes a complaint which is complicated, as here, it is proper for the banker to seek legal advice and review the documents in light of that advice: "you review the documents", he testified; "you talk to your legal [people]; then you make up your mind."

[**260] In addition, any obligations of Citibank or the Hongkong Bank of Canada to make outside enquiries were tempered by the contractual arrangements between those Banks and their Respondent customers. The terms and conditions contained in each application for a letter of credit -- and to which the issuance of the Letters of Credit were subject -- contained a provision which negates the obligation of the Banks [*121] to enquire as to existing disputes between the customer and the beneficiary of the credit. Mrs. Levin's application to Citibank is instructive in this regard. clause 4 of the Terms and Conditions states:

4.The Applicant hereby irrevocably authorizes Citibank Canada to make any payments and to comply with any demands which may be claimed from or made upon Citibank Canada in connection with the credit without any reference to or further authority from the Applicant [Emphasis start] and the Applicant agrees that it shall not be incumbent upon Citibank Canada ... to enquire[Emphasis end] or to take notice whether or not any dispute exists between any Beneficiary and the Applicant. The Applicant further undertakes that [Emphasis start] any payment which Citibank Canada shall make in good faith[Emphasis end] and in accordance with, or apparently or proposed to be in accordance with, the Credit shall be binding up [sic] the Applicant and shall be accepted by the Applicant as conclusive evidence that Citibank Canada was liable to make such payment.

(emphasis added)

[**261] The Hongkong Bank applications contained provisions to a similar effect, although not in the same language. [*122] The Applicant Royal Bank did not employ application forms like the others.

(iii) Onus

[**262] The onus is on the customer "to establish" clear or obvious fraud to the knowledge of the Bank. What does that entail?

[**263] In my view it entails the presentation of evidence corroborating the allegations of fraud that have been advanced, in the form of pertinent and contemporary documents such as are available, and verified by statements or affidavits from those with knowledge and information bearing on the issues -- to the extent possible, from independent sources: see, for example, United Trading Corporation S.A. v. Allied Arab Bank Ltd. , supra , at p.561.

[**264] Here, the Respondents have done just that, and they cannot be found lacking for their efforts in this regard. However, the sheer volume of documentation provided is not the criterion to be applied. "Clarity" and obviousness, are the by-words which govern.

[**265] Mr. Lenczner submitted that complex situations involving standby letters of credit -- where there are no documents underpinning the call or goods to examine behind those documents, and where proof of fraud is more difficult for the customer -- stand [*123] on a somewhat different footing than other letter of credit situations. It is not that the test is different, he argues, but that the Bank must be more flexible in the way it goes about the exercise of applying the test; it must work more with the customer. I do not think that this argument can be sustained. Its ultimate logic leads to the conclusion that the more difficult it is for fraud to be established, the easier it should be for the customer to establish it! Such a result cannot be right. Fraud may be difficult to establish because of the complex matrix of the

underlying transaction, to be sure; but it may also be difficult to establish because it simply does not exist in the circumstances. Letters of credit are not to be dishonoured in the latter situation.

[**266] The onus is deliberately high in these matters, for reasons that I have addressed above and which Mr. Justice LeDain made very plain in Angelica-Whitewear , supra . It is higher than a strong prima facie case -- a significantly high onus in itself. Mr. Lenczner submits that it is lower than the criminal law onus of proof beyond a reasonable doubt. I am not at all certain that proof beyond a reasonable doubt [*124] is too high an onus in circumstances where a Bank is called upon to make up its own mind with respect to the establishment of fraud, without the benefit of a Court determination to that effect; however, it is not necessary to articulate the onus in that fashion for the purposes of these proceedings.

[**267] The Supreme Court of Canada and the English Court of Appeal have avoided the temptation to articulate the level of onus for bankers in legal jargon, it seems to me, and have been content to express it in clear terms, but in lay terms; fraud which is "clear or obvious" must be "established" to the knowledge of the banks before the call is paid. It is readily apparent to those reading the relevant passages from Angelica-Whitewear and from Edward Owen Engineering that the onus is very high. Little is to be gained by embellishing it through an effort to articulate it in different words.

[**268] In the end, what a Court must do when called upon to review the Bank's decision to honour or not to honour a letter of credit on this ground, where there has been no injunction order made in advance and the Bank is called upon to make up its own mind, is determine whether the evidence [*125] supports a finding that the alleged fraud was sufficiently established to the knowledge of the Bank before payment of the draft: Angelica-Whitewear , supra , at p. 89. I find, in these proceedings, that it does not.

[**269] The approach to be found in the Walton memo to Mr. Wickremeratne of the Hongkong and Shanghai Bank, which I have reproduced earlier in this Reasons, commends itself to me in this connection. While the concept of clear and obvious fraud "is relatively undefined under English law", he pointed out, the dictionary definitions of "clear" and "obvious" are helpful. Do the materials provided to the Banks establish fraud in a way that is "unambiguous, easily understood, manifest, not confused and not doubtful" (i.e. "clear"); and in a way that is "easily seen or recognised or understood, palpable, indubitable" (i.e. "obvious") ?

[**270] Here, they did not.

(iv) Extraneous Considerations

[**271] The Respondents further argued that the Banks allowed themselves to be influenced in making their decision by the extraneous consideration of their reputations in the international market place. Mr. McNish, at least, acknowledged that he has given some consideration [*126] to that factor. While it is perfectly natural for a banker to be concerned about the affect of his or her actions on the reputation of the Bank -- in the interests of both the Bank and the banking community and the customers, who benefit from the international utility of letters of credit -- I agree that it is an extraneous consideration in determining whether or not to honour a letter of credit. The only relevant criteria are whether there has been documentary compliance and, if fraud is an issue, whether clear or obvious fraud has been established to the knowledge of the Bank. However, I am not able to conclude on the evidence here, that any of the Applicant Banks made their decisions to honour the Letters of Credit because of the international reputation factor, or that it even played any significant role in those decisions. I so find.

(b) Did the Banks Nest the Standards of the Bankers' Test?

[**272] I am fully satisfied that the Applicant Banks met the requisite standard in deciding to honour the Letters of Credit issued in favour of the Society and council of Lloyd's. They sought and obtained advice from their legal advisers. I find that they considered and reviewed [*127] the mass of materials which was provided to them carefully and thoroughly, and that they acted honestly and in good faith in their capacity as bankers in arriving at their respective conclusions that clear or obvious fraud had not been established to their knowledge. Their decisions did not turn on any irrelevant or extraneous considerations.

[**273] Indeed, I agree with their conclusion, based on the materials put before them -- which is not in any way to prejudge the determination of actual fraud which is to be made, as I understand it, in U.K. proceedings that are pending and which will be made on the basis of proper and admissible evidence after a trial. It was said at the outset of these proceedings that the U.K. trial, when it takes place, is estimated to last several months. One might be forgiven, it seems to me, for asking -- rhetorically, at least -- how bankers, who are neither lawyers nor judges, could be expected to determine that clear or obvious fraud had been established when it is expected to take a court such a long time to assess the evidence in that regard!

[**274] While, to be sure, there was a great deal of a critical nature regarding the "goings on," in [*128] the Lloyd's market, and regarding the practices of various participants in that market -- perhaps even of the regulatory practices of the Society and Council of Lloyd's as well -- the impugned conduct was as consistent with negligence or sheer incompetence, or even simple improper record keeping, as with fraud. Mr. White and Mr. Posgate both acknowledged that reasonable people could differ on these matters.

[**275] In United Trading Corporation S.A. v. Allied Arab Bank , supra . Lord Justice Ackner stated, at p. 561:

... The evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge.... If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud (for an injunction).

[**276] Here, the only inference to be drawn from the documentation and materials presented, as I have noted, and as the witnesses indicated, was not that of fraud, although some might draw that inference at least with respect to some of the issues. In the circumstances as I apprehend them, I would not be included in that group, however.

[**277] Moreover, there were [*129] materials amidst those put forward to the Banks which contradicted the Respondents' assertion of fraud. The affidavit of Susan Robinson states at the outset that she is "authorized and instructed by Lloyd's to so state, that Lloyd's deplores and emphatically denies the allegations of fraudulent conduct on its part" -- an admittedly bald denial, but nonetheless one facing the bankers charged with the responsibility of deciding whether "clear or obvious" fraud had been established. The same affidavit also stated that Lloyd's disputed it ever directed that information be kept from Names with respect to the Feltrim or Gooda Walker Syndicates. As well, it contained an explanation of the alleged removal of 24 million from the Feltrim Syndicate reserves which, if true, in my view removes the alleged non-disclosure of that removal from the category of clear or obvious fraud.

[**278] Nowhere in the Boswood opinion, which is put forward as the primary outline of the factual basis for the asbestos allegations, is there any mention of the word "fraud", much less of fraud on the part of the Society and Council of Lloyd's.

[**279] The Report of Sir David Walker regarding allegations that [*130] syndicate participations at Lloyd's were arranged to the benefit of working names and to the disadvantage of external names, and into the operation of the LMX Spiral, expressly negatived fraud. At paragraph 1.2 it stated:

The committee did not in its own investigations form a view that there was any fraud or conspiracy to disadvantage particular groups of names or to advantage others.

[**280] This Report, along with clippings from the London press with headlines reading "Gooda Walker cleared of fraud in Lloyd's report", were among the materials which the Banks were asked to consider. Moreover, in spite of a letter from Mr. Lenczner to the Banks assuring them that the forthcoming Report of Sir Patrick Neill regarding the Feltrim Syndicates and the LMX Spiral would support the allegations of fraud, it did nothing of the sort, and was also reported in the London press (copy to the Banks) as having cleared Lloyd's. A London publication, Lloyd's List of October 13 1992, stated:

Lloyd's cleared by

Feltrim report The Feltrim report, which comes a week after a report into the Gooda walker syndicate losses which had similar conclusions, is being greeted with relief at Lloyd's. [*131] Sir Patrick Neill's 1500 page inquiry into Feltrim syndicates 540/542 and 847 also dismisses allegations from some names that there was fraudulent or dishonest behaviour .

(italics added)

[**281] Sir Patrick Neill was critical of many matters concerning the operation of the Feltrim syndicates and, in particular of the LMX Spiral -- which he characterized as operating "in the event of a catastrophe so as to negate the basic principle insurance". Large portions of his Report were forwarded to the Banks, although not until the Pall of 1993. It is worthy of note, however, that the following passage from the Neill Report was not forwarded to the banks . Other portions of section 15 of the Report were provided; paragraph 15.3 was not. It says:

15.3It is right that we should state at this point that we have found no evidence of dishonest or fraudulent conduct or practices in the affairs of Feltrim or in the LMX market.

[**282] In my view it is simply not sustainable for the Respondents to argue, as they have done, that the Banks should have taken the Walker Report and the Neill Report -- and other reports as well - - and accept them only for the factual substratum which they [*132] provided, while ignoring their conclusions and coming to different (and opposite) conclusions themselves. Sir David Walker and Sir Patrick Neill had the benefit of hearing evidence and conducting wide-ranging enquiries. They were in a much better position to draw inferences and come to conclusions than were Messrs. Hunter, Wickremeratne, McNish and Chen. While the Banks could not ignore Sir Patrick Neill's conclusion, because it was withheld from them, its substance was reported in press clippings which they did have; and to expect the bankers to ignore those reports, and the conclusions of Sir David Walker which they did have, is to expect the Banks to make their decision in a crucible of unreality.

[**283] Similarly, the evidence with respect to the use of time and distance policies, either standing alone or taken cumulatively with the asbestos and LMX complaints -- as Mr. White maintained - - is not sufficient to establish clear or obvious fraud on the part of the Society or Council of Lloyd's. Time and Distance policies are described earlier in these Reasons. The facts relied upon by the Names in this respect were to be found primarily in an affidavit of Mr. Kenneth Randall, [*133] the former Head of Regulatory Services at Lloyd's, which had been submitted in the Boobyer v. Holman and the **Society of Lloyd's** action in England, and in a subsequent Report prepared by Mr. Randall's company along the same lines in April 1993. The thrust of the argument with respect to time and distance policies, as I apprehend it, is,

[**284] (1)that, because of their nature, they are financial instruments and not policies of insurance at all;

[**285] (2)that, their use enabled syndicates to overstate their profits; and,

[**286] (3)that the Society and Council of Lloyd's, as regulator of the market, must have known this was going on and failed to correct it or, at least, to ensure that the practice was disclosed to the Names.

[**287] Even Mr. White acknowledged in cross-examination, however, that there was nothing wrong with time and distance policies, themselves and agreed that the Randall affidavit itself did not establish clear or obvious fraud. Moreover, the Randall affidavit states that "time and distance policies are used extensively in the Lloyd's market (as well as in other insurance markets)", and notes that "although it has financing characteristics, a [*134] time and distance policy is generally accepted in the London Insurance Market by Lloyd's as a contract of insurance". In his April 1993 Report, through his company Randall Insurance Services Ltd., Mr. Randall writes:

2.2[Emphasis start] It is RISL'S view that there is nothing improper about the use of time and distance reinsurance provided[Emphasis end] (i) there is full disclosure of material transactions and (ii) cash flow forecasts are prepared to test whether the closing year will have sufficient cash to meet claims as they fall due for payment.

(emphasis added)

[**288] The controversy surrounding time and distance policies, and the Reports on them, were widely covered in the London press, copies of which were also forwarded to the Banks to digest as part of their decision making process. While Mr. Randall's affidavit and Report, along with the press, would certainly indicate to the Banks that the use of these policies had its frailties and ran the risk of exposure to underwriting members, they would also have seen the reference to the use of these financial devices as being widely accepted and legitimate. For instance, The Independent reported in an article on April [*135] 2, 1992 that, Time and distance policies are reinsurance contracts under which funds are released at an agreed date in the future, to meet an insurance syndicate's long-term cash needs. The contracts are normally placed overseas. [Emphasis start] The contracts are widely and legitimately used in the Lloyd's market to stabilise syndicates' cash flow.[Emphasis end] Lloyd's has always argued that their use is correct.

(emphasis added)

[**289] There is no reference in any of the materials presented to the Banks regarding time and distance policies to fraud. Certainly, there is no reference to fraud on the part of the Society or Council of Lloyd's. The closest that one can come to a reference to fraud, is the fact that apparently Mr. Randall's Report was referred to the London Serious Fraud Squad. There is no indication, however, that any charges have been laid as a result, or are even being considered, and if so, against whom.

[**290] I am at a loss to understand how the Banks could have been expected to conclude, on the basis of all of the materials respecting time and distance policies provided to them, that clear or obvious fraud in that respect had been established. [*136]

[**291] Most of the complaints centred around the use of the time and distance devices by various of the Gooda Walker Syndicates, although in letters sent by the Respondents Darlington, Gaukrodger, Munro and Symons to the Royal Bank, the allegation was made that certain Cuthbert Heath Syndicates falsified their records, and their balance sheets, by using "abnormal" time and distance policies to cover IBNR losses. There was little material provided to the Banks with respect to the Cuthbert Heath allegations, as the Randall materials and the bulk of the press clippings which were forwarded concentrated on the Gooda Walker allegations. As Mr. Glezos pointed out in argument, there is no evidence to show that any of the particular Royal Bank Respondents underwrote any of the Gooda Walker Syndicates in question or, even if they had, that they relied in any fashion on the reported results of such Syndicates which allegedly used the time and distance policies to enhance their results. The same observation can be made with respect to all Respondents, in my view. While Mrs. Levin's affidavit states that everyone underwrote either Feltrim Syndicates 540/542 and 847 or Gooda Walker Syndicates [*137] 164, 290, 295, 298 and 387, or combinations of both, it was not possible for the Banks to sort out which Respondents were on which Syndicates. Mr. White admitted in cross-examination that he could not tell what Syndicates any of the Respondents were on.

[**292] Certain groups of Respondents -- particularly the Royal Bank Respondents -- made somewhat different fraud allegations in relation to the time and distance policies. I might note in passing, as well, that the same is true with respect to the LMX Spiral and both the Gooda Walker and Feltrim Syndicates. To the extent that it was necessary for the Banks to be able to connect the particular allegations of fraud with particular Respondents, then, it was not possible for them to do so. I do not feel it necessary, for the purposes of these Reasons, to deal with the Time and Distance Policy allegations, or the LMX Spiral allegations, on a Respondent by Respondent basis (or a group by group of Respondents basis) because on an overall basis the establishment of clear or obvious fraud with respect to these categories has not been made out. I am supported in this conclusion, as I have already pointed out, by the evidence of Mr. White, [*138] the Respondents' expert, who was also of the view that neither the Time and Distance Policy argument nor the LMX Spiral argument formed a stand-alone basis for the establishment of fraud.

(c) Fraud of which the Beneficiary Cannot be Said to be Innocent

[**293] It was submitted by the Respondents that, even if the examples of fraud alleged had not been committed by the Society or Council of Lloyd's themselves, but by underwriting or managing agents, the fraud was nevertheless fraud of which the beneficiary cannot be said to be innocent. In Angelica-

Whitewear , supra , at pp. 83-84, Mr. Justice LeDain stated: I agree with the view expressed in United City Merchants that the fraud exception should be confined to fraud by the beneficiary of a credit and should not extend to fraud by a third party of which the beneficiary is innocent. This appears to me to be a reasonable limit in principle on the scope of the fraud exception....

[**294] It is implicit in the foregoing comment that the fraud exception in letter of credit cases might extend to fraud by a third party of which the beneficiary of the letter of credit cannot be said to be innocent. The argument here is that because [*139] of the regulatory control which the Society and Council of Lloyd's exercised over the Lloyd's market, and the knowledge which they possessed as a result of that position, the Society and Council could not be "innocent" third parties to the fraud's perpetrated by others in the market. There are a number of problems with this submission, not the least of which is that the evidence tendered to the Banks does not support a finding that clear or obvious fraud on the part of anyone else was established to the knowledge of the Bank -- as I have found. Moreover, it would take evidence of the simplest and most convincing nature, I should think, before Courts should impose an obligation upon bankers to make decisions based upon concepts of vicarious liability and/or conspiracy in the context of making a decision about whether or not to honour a letter of credit. one or another of these principles would have to apply to make the necessary nexus between the fraudulent conduct of a third party and the beneficiary. Otherwise, the fraud in question would be the fraud of the beneficiary itself, i.e., in the present context, it would require proof that the Society or Council of Lloyd's themselves [*140] had the requisite fraudulent intent or displayed the sort of recklessness which is tantamount to such intent.

(d) Fraudulent Intent

[**295] Mr. Lenczner submitted that the fraud in question in these proceedings consisted of recklessness moreso than of intentional deception. He argued that it is not necessary to show an intention to cheat or to injure, so long as recklessness, in the sense of wilful blindness, can be established.

[**296] The concept of recklessness as fraud is present in the classic definition of fraud articulated by Lord Herschell in Derry v. Peek (1889), 14 App. Cas. 337, at p. 374:

I think the authorities establish the following propositions: First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of [*141] what he states. To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth.

[**297] In Baltimore Aircoil of Canada Inc. v. Process Cooling Systems Inc. (1993), 16 O.R. (3d) 324 (Ont. C.J., Gen Div) Rosenberg J. articulated the concept of wilful blindness in such circumstances in the following words: A misrepresentation is fraudulent and not merely negligent when it can be said that its maker has an absence of honest belief in its truth or when its maker has shut his eyes to the facts or purposely abstained from inquiring into them: Francis v. Dingman (1983), 43 O.R. (2d) 641 (C.A.) at p. 649, 2 D.L.R. (4th) 244 at p. 253.

[**298] Here Mr. Lenczner submits that the Society and Council of Lloyd's -- really the Council, or what he refers to as the capital "C" Committee of the Council to which the running of the day-to-day operation of the Lloyd's market has been delegated -- were careless in allowing misleading information to be disseminated to actual and potential Names, and that they were wilfully blind to situations of which they were painfully [*142] aware. The Banks, this argument concludes, placed too much emphasis on a search for dishonest or deceitful intention on the part of Lloyd's, and paid not enough attention to whether there had been recklessness, in the sense defined, on the part of the beneficiary of the Letters of Credit.

[**299] While it is accurate that recklessness in the sense referred to can amount to fraud, it remains the case, however, that the "fraudster" must lack an honest belief in the statement or representation made (whether it be made directly, or by way of non-disclosure): see Derry v. Peek , supra , in the passage cited above. The documentation and information presented to the Applicant Banks in these proceedings cannot be found, in my view, to have established any such lack of honest belief on the part of the Society or Council of Lloyd's.

[**300] The necessity, and the difficulty, of establishing fraudulent intention in corporate situations has recently been revisited by the British Columbia Court of Appeal and the Supreme Court of Canada in BG Checo International Ltd. v. British Columbia Hydro & Power Authority (1990) 4 C.C.L.T. (2d) 161 (B.C.C.A.); (1993) 14 C.C.L.T. (2d) 233 (S.C.C.). [*143]

[**301] Checo had been the successful bidder on a tender put out by Hydro to build two sections of an electric transmission line in British Columbia. The tender documents, while charging prospective bidders with the task of inspecting the job site, stated: "Clearing of the right-of-way ... has been carried out by others and will not form part of this Contract." Unfortunately for Checo, it had not been disclosed that the right-of-way along which the line was to be constructed was obstructed with logs and other debris. Checo suffered significant losses on the contract. Although the action had proceeded on the basis of negligent misrepresentation and breach of contract, an amendment alleging fraud on the part of Hydro was allowed at trial and the trial judge found Hydro liable on that basis. on appeal, the B.C.C.A.

overturned the finding of fraud, but gave judgment on the basis of negligent misrepresentation. The Supreme Court of Canada held that the Court of Appeal had rightly dismissed all suggestions of fraud, for want of any evidence to deceive. It imposed liability on Hydro on the basis of both contract and negligent misrepresentation.

[**302] In the B.C.C.A., Hinkson J.A. [*144] for the majority stated:

... The structure and operations of corporations are becoming more complex. [Emphasis start] However, the fundamental proposition that the plaintiff must establish an intention to deceive on the part of the defendant still applies[Emphasis end]. In Rainbow Industrial Caterrers Ltd. v. Canadian National Railway Co. (1988) 54 D.L.R. (4th) 43 (B.C.C.A.) ... Wallace J.A. said at p. 313:

"In the K.R.M. case both the trial judge and the British Columbia Court of Appeal found that the defendants did not have an honest belief in the truth of the representation made to the plaintiff and that they made such representation because they were well aware that otherwise an agreement between the parties would have been impossible.

In my view, neither decision can be construed as authority for the proposition that fraud based on misrepresentation through non-disclosure can be established in the absence of an intention on the part of the representor to deceive and thereby defraud the representee.

In my view, the trial judge erred in his analysis of the elements which must be strictly proven to bring home a finding of fraud on the part of the [*145] defendant. At the very least, the circumstances must establish dishonest conduct on the part of the defendant. [Emphasis start] He must be found to have intended to deceive the plaintiff by his failure to disclose to the plaintiff the relevant information and. as a result. have intended to commit a fraudulent act by such non-disclosure equivalent to that which would prevail had he made a false statement knowing it to be false[Emphasis end]." In the present case, a committee of 12 prepared the specifications. The evidence does not reveal that any members of the committee were dishonest in the preparation of the specifications for this contract. Rather, it is possible to conclude that they mistakenly and negligently believed that the requirement that the tenderer should take a view of the site would remedy any shortcomings in the specifications included in the terms of the contract.

(emphasis added)

[**303] There are parallels between BC Checo and the allegations of fraud being made in these proceedings. in both situations the conduct which is impugned is capable of being construed as negligence, breach of contract, or, in the view of sone, fraud. In these proceedings, [*146] the Society and Council of Lloyd's are said to have committed a fraudulent non-disclosure by allowing a fraudulent situation to exist in the Lloyd's market in respect of asbestos reserves, the LMX Spiral, time and distance policies and the other matters complained of, and by failing to warn prospective Names, including the Respondents, of these circumstances. But what is the evidence regarding the intention of the persons who formed the directing minds of the beneficiary of the Letters of Credit who is alleged to have been fraudulent ? In respect of the LMX Spiral and the Time and Distance policies, there is absolutely none. In respect of asbestos, Mr. Posgate -- who was a member of the Council and the Committee of Lloyd's – testified that the members of the Committee discussed the contents of the Neville Russell letter and the Murray Lawrence response, but did not discuss the question of leaving the account years open. I do not think a fraudulent intent can be found on that evidence alone.

[**304] Moreover, the complex structure of Lloyd's raises the frequently troublesome exercise of ascertaining fraudulent intent in corporate situations to an even more complicated level. Where [*147] does the requisite intention lie, if indeed it existed? Is it with the Society? The Council? The Committee of Lloyd's? The sub-Committees to which the day-to-day operations of the Lloyd's regulatory system delegated? There is nothing in the documentation and information presented to the Applicant Banks, in my opinion, which establishes any such intent on the part of the directing minds of the Society or Council of Lloyd's. The highly sophisticated and intricate nature of the enquiry is yet another example of why it is an exacting task to give to bankers, and. accordingly, of why, in my view, the test and the standard are so high.

(e) "Reasonable Banker" Standard Met as Well

[**305] Even if I am in error in my conclusion that the banker's test to be applied in determining whether clear or obvious fraud has been established is not the objective standard of the "reasonable banker", I am satisfied on the evidence here that the Applicant banks met such a standard in any event.

[**306] Based upon the evidence of the two experts, Mr. Bergin and Mr. white, it is apparent that two reasonable bankers could arrive at different conclusions, given the materials presented. Mr. White acknowledged [*148] that bankers could differ.

[**307] The Applicant Banks took all steps that were reasonably necessary, in my view, to arrive at their decision. They sought, and acted upon, legal advice. They examined the documentation and materials presented to them carefully and thoroughly. For the most part, they accepted that "evidence" at its face value. They made up their own minds, which is what they were obliged to do. This is exactly the procedure which Mr. White testified should be followed. The gauge by which to measure the Banks' conduct -- even on this view of the standard -- is not whether they came to the same conclusion as another group of Canadian Banks facing similar demands, but whether they have discharged their

obligations as bankers reasonably in the circumstances. For all of the reasons which I have articulated already, I find that they did.

PART IV

BANK CLAIMS FOR INDEMNIFICATION

[**308] The provisions of UCP 400, Article 16a, and the contractual arrangements between the Respondents and the Applicant Banks each oblige Respondents to reimburse and indemnify the Banks in the event of payment by the latter under the Letters of Credit. it was submitted by Mr. Lenczner and [*149] Mr. Smith, on behalf of the Respondents, however, that the Banks were not entitled to indemnification for payment under certain of the Letters of Credit,

[**309] a) because the Banks had breached a duty to explain to their customers that the Letters of Credit could be called upon at will, without any proof of loss on the part of Lloyd's, and that they contained "evergreen" provisions;

[**310] b) because in certain instances the Banks had failed to comply strictly with the instructions of their clients, on whose behalf the Letters of Credit had been issued;

[**311] c) because in certain instances the Indemnity Agreements between the Bank and the customer stipulated for indemnification pursuant to a letter of guarantee, whereas what had been issued was a letter of credit; and,

[**312] d) because, in the case of the HongKong Bank of Canada Letters of Credit, there had been an unauthorized change in conditions when the letters of credit were transferred from Lloyd's Bank Canada to the HongKong Bank of Canada.

A. DID THE BANKS HAVE A DUTY TO ADVISE THEIR CUSTOMERS AT THE TIME OF ISSUANCE OF THE LETTERS OF CREDIT?

[**313] Does a banker who is asked to issue a letter [*150] of credit on behalf of a customer have a duty to provide advice to the customer regarding the letter of credit ? If so, what is the extent of that duty ?

[**314] Mr. Lenczner was very clear in making his submissions on this point that he was not seeking to found the Respondent's case on either a fiduciary duty on the part of the Banks or upon the principle of non est factum . He argued simply that the bankers had a duty of explanation to their customers, in the circumstances herein, to advise the Respondents,

[**315] a)that the type of standby letter of credit which they were requesting could be called upon by the beneficiary, Lloyd's, without proof of loss and at will;

[**316] b)that the letters of credit contained an "evergreen" provision, i.e., that they were automatically renewable every four years unless notice of cancellation was given four years in advance; and,

[**317] c)that, in circumstances such as these, where the customer had an option to provide Lloyd's with either a letter of credit or a letter of guarantee, bankers should explain the huge differences between the two instruments and point out that the letter of guarantee is much more favourable to the [*151] customer.

[**318] The expert witnesses and the Bankers were asked about this duty in evidence. They generally concurred, with varying degrees of emphasis, that if the customer asked, or appeared not to know what they were getting into, they would explain that the credit could be called upon at any time by Lloyd's, for any reason, and without proof of loss.

[**319] Again, not surprisingly, there were differences between the evidence of Mr. Bergin, the Banks' expert, and that of Mr. White, who was called on behalf of the Respondents. Mr. Bergin felt, in the circumstances of these proceedings, that there would be no obligation on the Banks to advise the Names, because the nature of the transaction itself -- that is, the fact that it took place in the context of becoming a Name at Lloyd's, and that the Respondents were presenting to the Banks what they had been asked by Lloyd's to sign -- indicated a sufficient level of sophistication on the part of the customer to be a token that they understood what they were doing. Mr. White, on the other hand, stated that he would first determine whether the customer understood how to fill out the application for the credit, following which [*152] he would ascertain whether the customer knew what the obligations were that he or she was undertaking. Given the form that was presented, Mr. white would have advised the customer that a demand could be made by Lloyd's at any time, without other documentation, and that the letters of credit contained "evergreen" provisions. Finally, if the customer came to him and said he or she could provide one of two forms to the beneficiary -- a letter of credit or a letter of guarantee -- he would have suggested the latter because it provided more protection to the customer.

[**320] Both Mr. White and Mr. Bergin agreed, however -- as did the bankers who were asked -- that what a banker would do is a factually driven question, depending upon the circumstances of each case.

(a) The Circumstance Hare

[**321] What were the circumstances in these proceedings ?

[**322] By virtue of their contractual relationship with the **Society of Lloyd's** upon becoming a Name, each Respondent was obliged to provide either a letter of credit or a letter of guarantee as security for the deposit against which they would be entitled to underwrite insurance. whichever instrument was chosen, the Members' Underwriting [*153] Security Agreement dictated that it be in "a form which has been approved by the Society".

[**323] I find that each Respondent requested his or her respective Bank to provide a letter of credit in precisely the form required by Lloyd's. It is clear from the evidence as well, and I so find, that none requested a letter of guarantee. Moreover, I find that none of the Respondents asked the Banks for advice with regard to the nature of the financial instrument they were requesting be issued on their behalf or with regard to the difference between a letter of credit and a letter of guarantee. It is equally clear that no advice was given by the Banks as to the difference between the two instruments.

[**324] Whether advice of a general nature was given to the Respondents with respect to the letter of credit is not so clear. The facts in relation to the various Respondents, in this respect, may be summarized as follows.

(i) The Royal Bank Respondents

[**325] Of the Royal Bank Respondents neither Peter Clarke nor Gordon Symons filed a witness statement/affidavit or testified. There is nothing to indicate that their Letters of Credit were not opened precisely in accordance with their [*154] instructions and with their full understanding.

[**326] Dr. O'Neil and Dr. Munro filed witness affidavits, but did not testify at trial. Mr. Smith and Mr. Jansons, who dealt with them on behalf of the Bank, respectively, testified that neither asked for any advice and neither was provided with any advice. The bankers simply followed their customers' instructions.

[**327] Mr. Darlington testified. He is a former Vice President of Beaver Lumber Company who ran that company's international trade department and who was familiar with letters of credit in that capacity. He acknowledged that he understood all that was required from the Society and Council of Lloyd's was the presentation of a sight draft.

[**328] Dr. Gaukrodger also testified. He was very clear that he gave a sample letter of credit to Mrs. Cobus at the Bank and instructed the Bank to open a letter of credit in accordance with the sample. The Bank did so. on reading the letter of credit during his cross-examination, Dr. Gaukrodger readily agreed that it allowed the credit to be called upon by presentation of a sight draft without further documentation.

[**329] Dr. Laird Jennings testified. He had had prior experience [*155] with letters of credit being issued on his behalf in connection with another venture. He provided Mr. Brown, the account manager at the Bank with brochures regarding the Lloyd's investment and a sample letter of credit and sample letter of guarantee. He instructed Mr. Brown to open a letter of credit in favour of the Society and Council of Lloyd's, and Mr. Brown followed his instructions. Dr. Jennings couldn't recall having read the sample letter of credit when receiving it from Lloyd's, but he readily understood, upon reading it at trial, that only the presentation of a sight draft was required to trigger it. Mr. Brown testified that he advised Dr. Jennings that the letter of credit could be drawn at any time by Lloyd's, and I accept that evidence. Dr. Jennings had both a lawyer and an accountant who were readily available for consultation, but chose not to consult with them.

[**330] Peter Palmer filed an witness affidavit, but did not testify at trial. At the time in question, he was the manager of Richardson Greenshields in Hamilton. He provided the Bank with a sample letter of credit and a sample letter of guarantee, but instructed Mr. Brown to open a letter of credit. The [*156] Bank followed his instructions. There is no indication that Mr. Palmer either asked for or received advice from the Bank.

(ii) The Hongkong Bank Respondents

[**331] The representative of the Hongkong Bank who dealt with the Respondents Sean McDonough, Hugh and Marjorie Hendrie, Anne Hendrie, Ian Taylor and Jane and William Perrin, was Mr. Edward Irving. He is the retired former manager of Lloyd's Bank of Canada (Hongkong Bank's predecessor) in the Hamilton area. He testified that it was his invariable practice to explain to his customers how a letter of credit works.

[**332] Sean McDonough did not raise any questions with Mr. Irving. Mr. McDonough was already a Lloyd's Name when he first came to the Bank, and he asked the Bank to issue the same letter of credit as he already had had through the CIBC. The Bank did so. Mr. McDonough had a lawyer advising him in connection with the transaction.

[**333] Hugh Hendrie is an older gentleman who is a sophisticated investor, earning his living from the operation of his investments. Mr. Hendrie testified at trial. He could not remember receiving any advice from Mr. Irving, but admitted that he had a large investment portfolio and [*157] a lawyer and accountant advising him. Mr. Irving testified that he had advised Mr. Hendrie of the risks involved in dealing with letters of credit. Mr. Hendrie's recollection of the events surrounding the transactions, by his own admission, was hazy. I accept Mr. Irving's testimony on this point -- as, indeed, I accept it on all points -- and find that he did, in fact, advise Mr. Hendrie of the risks surrounding the use of letters of credit. In any event, Mr. Hendrie was a sophisticated investor, and I am sure understood these risks independently.

[**334] Mrs. Marjorie Hendrie, the wife of Hugh Hendrie, testified too. She did not meet with the Bank, but was content "to leave things to [her husband]". She recognized the family had solicitors and accountants. In the circumstance, Mrs. Hendrie constituted Mr. Hendrie as her agent, for purposes of the issuance of her letter of credit, and is bound by her husband's conduct in regard to them, in my view.

[**335] The Respondent Anne Hendrie is the daughter-in-law of Hugh and Marjorie Hendrie. Mr. Irving recalls specifically speaking with her, and dealing with her concerns, and I find that he did SO. She wrote a letter to Mr. Irving [*158] indicating that she required a letter of credit, and enclosing a sample of the form required. She also indicated that she had a lawyer, who was available to be spoken to by Mr. Irving if he had any questions or if any changes were required. The letter of credit was issued as instructed.

[**336] The Respondent Ian Taylor operates a furniture business in Hamilton. He has offshore interests and investments. Mr. Irving explained to him that there was a four stage process in the event of his becoming liable on his investment as a Name: first, Lloyd's would look to whatever profit he had in the trust fund held by Lloyd's; secondly, Lloyd's would notify him personally; thirdly, Lloyd's would go to the Bank, and the Bank would then notify him; and, fourthly, Lloyd's would call down the letter of credit. Mr. Taylor acknowledged that these four steps were a good description of what actually happened eventually. Mr. Taylor also had a lawyer advising him.

[**337] The Respondents Jane and William Perrin filed a witness affidavit, but did not testify at trial. The Perrins operate a very successful automobile dealership in Hamilton. Mr. Perrin's net worth at the time exceeded $2 million. [*159] They each deposed that they were not advised or warned that Lloyd's could draw on the letter of credit without demonstrating to the Bank any underwriting loss. Neither indicated that they asked for such advice. At the same time, I cannot conclude on the evidence that they were given any, either.

[**338] The Respondent Thomas Parrott has a small property management business in Ottawa and at the time had a net worth of over $1 million. He is a retired public servant. A modest amount of vanity prevented him from disagreeing with the Bank's assessment of him as an astute businessman, he conceded. He requested and received a letter of credit in accordance with his instructions. He was not advised that Lloyd's could draw on the letter of credit at will without a loss. He did not ask for advice either. He had never been involved with a letter of credit before and testified that, if he had known that Lloyd's could draw upon the letter of credit without a loss, he would not have signed the letter of credit.

[**339] The final Hongkong Bank Respondent is Edward Reynolds. I am advised that Mr. Reynolds is bankrupt. The proceedings are thus stayed against him, and nothing further need [*160] be said regarding the Bank's claim against him.

(iii) The Citibank Canada Respondent

[**340] Mrs. Levin is the sole Citibank Canada Respondent. She did not testify at the trial. Although her various affidavits serve as the primary outline of the Respondents' case in the proceedings, she had no direct dealings with Citibank in connection with the issuance of her Letter of Credit. Like Mrs. Marjorie Hendrie, she relied upon her husband, Dr. Levin, to make the arrangements with the Bank's representative. Mrs. Levin had substantial assets in her name, and was the manager of her husband's successful dental practice.

[**341] Mrs. Shelagh Coward is the Citibank representative who dealt with the Levins. She testified that she formed the opinion, based upon Mrs. Levin's involvement in the dental business and the "unusual and interesting" asset statement which was provided, and which showed a good proportion of the assets in Mrs. Levin's name, that Mrs. Levin was a person with substantial business acumen. I suppose that Mrs. Levin's integral involvement in the Lloyd's lawsuits is at least some confirmation of her inclinations and abilities in this regard, and of Mrs. Coward's assessment. [*161]

[**342] In any event, Mrs. Coward testified that she was not asked by Dr. Levin to explain how letters of credit work. I think it is a fair inference from the evidence that she did not provide such an explanation either. She received a note from Dr. Levin enclosing a document that was described as "self-explanatory" and said to have come "as part of a series of documents from London". The enclosures consisted of a letter from the Lime Street Underwriting Agencies Ltd. -- the Levin's Members' Agent – together with a letter of credit form which "require[d] completion in support of your Application for Underwriting Membership of Lloyd's". The letter of credit form is a one page document which, like those of all the Respondents, contains the following clear and simple paragraph: Funds under this Credit are available to you against your sight draft(s) drawn on us at our London office or the London branch of the confirming Banks where applicable, mentioning thereon Credit No. (INSERT NO.) and our reference (INSERT REF.).

[**343] It was apparently "self-evident", at least to Dr. Levin, that the letter of credit could be drawn upon simply by the presentation of a sight draft as referenced, [*162] without more.

[**344] The Lime Street Underwriter's letter is also interesting for its indication that Dr. Levin had already stipulated in his Statement of Means , provided to Lloyd's as part of the process of applying for membership, that he would be providing his Lloyd's Deposit by way of a Letter of Credit. This confirms what I surmise to be the case in many of these situations, namely that the decision to furnish a letter of credit was something that had been made long before the Name came to the Bank to request that one be issued, and was not something regarding which the Customer either wanted or expected advice.

[**345] Mrs. Levin denies that she ever met with a representative of Citibank, and Mrs. Coward candidly acknowledged that she is not sure that she ever met or conversed with Mrs. Levin. I am satisfied on the evidence that no such meeting or conversation ever took place, but Mrs. Levin -- like Mrs. Hendrie, too – is bound by her husband's dealings on her behalf.

[**346] In addition, however, Mrs. Levin received independent legal advice with respect to the borrowings of the Levins from the Bank. Mrs. Levin was required to provide collateral security in support [*163] of Dr. Levin's obligations, including the granting of a mortgage. She obtained independent legal advice from a solicitor "as to the advisability [of her providing the listed security) for the purpose of securing the liability of [Dr. Levin] to [Citibank] ... the amount of which is as follows: LETTER OF CREDIT 70,000 Sterling, and Revolving Line of Credit, - Canadian equivalent of 209,000 Sterling." Although counsel argued strenuously on Mrs. Levin's behalf that this independent legal advice was with respect to a different indebtedness, it was nonetheless independent legal advice with respect to a common overall transaction on the part of the Levins, and was with respect to a letter of credit which was in identical form to that provided for the account of Mrs. Levin, and which was provided in favour of the same beneficiary and furnished in connection with an identical parallel application for Membership at Lloyd's. I conclude that Mrs. Levin was fully advised and versed on the question of her obligations as provider of a letter of credit in favour of the Society and Council of Lloyd's.

(b) The "I Wouldn't Have Signed if I Had Known" Claim

[**347] Mr. Parrott is not the only Respondent [*164] to claim that he would not have provided a letter of credit had it been made clear that the letter of credit could be called upon without any loss, or proof of loss, on the part of Lloyd's, or without some prior demand by Lloyd's. The emphasis varied. I have no difficulty in concluding that each of the Respondents who gave such evidence believed that to be the case at the time they gave the evidence, looking back with the benefit of hindsight. I do not accept that such was the case at the time the arrangements were made for the letters of credit to be issued, however.

[**348] The Respondents had each committed themselves to become Names at Lloyd's, and they were obliged by the terms of their contracts with the **Society of Lloyd's** to provide either a letter of credit or a letter of guarantee in the form approved by Lloyd's . They did no more than abide by their agreement. Moreover, it must be remembered that the letter of credit is simply a means of providing security for the Names' deposit obligations without actually posting cash for that purpose. It does not alter or extend the Name's exposure or liability; it simply equips the **Society of Lloyd's** with a quick and clean way of [*165] calling upon that liability. I am not prepared to find on the evidence that the Respondents would have declined to furnish the letters of credit solely for the reasons so stated.

[**349] It may be that upon more considered reflection the Respondents, or at least some of them, would have chosen to tender a letter of guarantee rather than the letter of credit. This raises the question whether the Banks had a duty to advise their prospective customers about the differences between the two instruments. I shall return to that question momentarily.

(c) The Law Regarding a Banker#& Duty to Advise

[**350] I should think that if a customer were to ask a banker for an explanation as to the effect of providing a letter of credit or as to the difference between a letter of credit and another financial instrument, the banker would be under some obligation either to provide such an explanation or – perhaps more wisely - - to send the customer off to obtain some independent legal advice on the subject. None of the Respondents in these proceedings requested any such explanations, however.

[**351] In circumstances where no advice or explanation is requested, however, there is no ringing [*166] consensus amongst the experts and bankers who testified as to extent of any such duty. They all agree that it depends upon the factual circumstances of each case.

[**352] On the facts in these proceedings, as I have just reviewed them, and as I find them to be, I hold that there was no duty on the part of the Applicant Banks to advise the Respondents or offer any explanation to them. In particular, there was no duty to explain to them that the letters of credit could be called upon at will by Lloyd's and without proof of loss (it was "self-explanatory" from the Lloyd's-approved letter of credit form that this could be done); or that they contained an evergreen provision (an argument that I fail to understand, but the impact of which provision was also patently clear from a reading of the approved form); or that a letter of guarantee offered more protection to them than did a letter of credit (they were only asked to provide a letter of credit, not to recommend and provide the better product).

[**353] As I have noted above, Mr. Lenczner does not seek to found this part of the Respondents' defence upon the existence of either a fiduciary relationship or the principle of non est [*167] factum . Nor does he submit that the letter of credit transactions between the Respondents and the Banks were unconscionable, and therefore should not be enforced. He simply argues that a duty to advise and explain exists in the circumstances.

[**354] All of the bankers and the experts agreed that bankers need to be loyal to their customers and sensitive to their needs. To my mind, however, such an obvious characteristic of the relationship between banker and customer does not, by itself, elevate that relationship beyond the ordinary one of debtor and creditor. There must be special or exceptional circumstances to do that.

[**355] If such a duty to advise or to explain exists in the context of a letter of credit transaction, it cannot be a duty to advise or to provide explanation with respect to the customer's investment or the suitability of furnishing the letter of credit. To do so it would be necessary for the Bank to delve into the underlying transaction between the customer and the proposed beneficiary of the credit -- a terrain which is expressly forbidden by the fundamental nature of the law relating to documentary credits. Even

Mr. White agreed that the Bank had no [*168] obligation to advise a customer about the suitability of the arrangement between the customer and Lloyd's.

[**356] It was that sort of duty to advise as to the suitability of the investment in question which led to liability on the part of banks in cases such as Hayward v. Bank of Nova Scotia (1985), 51 O.R. (2d) 193; 19 D.L.R. (4th) 758; 10 O.A.C. 391 (Ont. C.A.) -- the exotic cow case -- and Lloyds Bank Ltd. v. Bundy [1975] Q.B. 326, [1971] 3 All E.R. 757 (C.A.) -- the "old Mr. Bundy" as mortgagor case. In those cases, the Banks found themselves in a conflict of interest position, dealing with customers who were particularly vulnerable and dependent upon them for advice and seeking to strengthen their own position at the same time. Nothing of the sort exists in these proceedings.

[**357] Bankers and customers normally enter into ordinary commercial transactions as arms-length lenders and borrowers. This principle is well established in the authorities, and has most recently been reinforced by Mr. Justice Ground in Re Mastercraft Group Inc. [1994) O.J. No. 941. at pp. 20-23 [*169] (Ont. C.J., Gen Div).

[**358] Re Mastercraft Group Inc. involved monies loaned by financial institutions by way of mortgage and equity financing in a series of condominium-limited partnership-tax shelter investments. Ground J. declined to find either a fiduciary relationship or a breach of a banker's duty of care to customers. At P. 21 of the judgment he said:

... Even if a [financial institution] did have some concern as to the financial viability of a particular project, the law does not in my view impose any duty on a financial institution lender to analyze or advise a borrower as to the viability of an investment to which the borrower proposes to apply the proceeds of a loan from the financial institution. [Emphasis start] The relationship between a financial institution lender and its customer borrower is a purely commercial relationship of creditor and debtor and. In the absence of some special relationship or exceptional circumstances, the courts have held that the lender owes no duty of care to the borrower[Emphasis end] and where a customer of a bank borrows money to finance an investment in a business, in the absence of any fiduciary relationship, the bank owes no duty [*170] to its customer to scrutinize or monitor the use of those funds.

(emphasis added)

[**359] See, to a similar effect, Standard Investments Ltd. v. C.I.B.C. 45 O.R. (2d) 16, at p. 45 (per Griffiths J., as he then was, at trial, in the context of a fiduciary relationship discussion); affirmed on appeal, (1985) 52 O.R. (2d) 473, at p. 495 (Ont. C.A.). See also, Shoppers Trust Co. v. Dynamic Homes Ltd., Nigro and Nigro (1992), 10 O.R. (3d) 361, at pp. 365-371 (Ont. C.J., Gen Div, E. Macdonald J.).

[**360] Earlier, and in a similar vein, in the Hayward v. Bank of Nova Scotia decision, supra , at pp. 760-761 (D.L.R.), Houlden J.A. had noted: It follows that rarely will the ordinary loan transaction be set aside. [Emphasis start] It must be a transaction to the manifest disadvantage to the customer and the banker must have and exercise a dominating influence either directly or indirectly over the customer.[Emphasis end] In those circumstances the relationship will arise imposing the duty upon the banker to ensure that the customer formed an independent judgment based upon full disclosure [*171] before entering into the transaction.

(emphasis added)

[**361] In my opinion, no such dominating influence existed between the Banks and the Respondent customers in these proceedings with respect to the issuance of the Letters of Credit.; nor were there any circumstances of vulnerability or dependency which could give rise to any relationship other than that of ordinary lender and borrower. The Respondents were each arms-length commercial customers who came to the Banks with the form of instrument they were seeking to have issued on their behalf (and which, indeed, they were required by contract with Lloyd's to have issued). They requested the Banks to issue that instrument. The Banks did SO. No one asked for any advice. Most had independent legal and accounting advice available to them, and some even took such advice. With the exception of Mrs. Marjorie Hendrie, and the possible exception of Mrs. Perrin (who did not testify), they were all reasonably sophisticated people with business experience. To the extent that they were careless in not protecting their own interests, or were content to rely on others to do so, they cannot shift the responsibility for that conduct to [*172] the Banks in these circumstances. No duty to advise or to explain arises in a relationship of the sort which existed between the Banks, as issuers of the Letters of Credit, and the Respondents, as customers requesting their issuance, in my view, and none existed here.

B. STRICT COMPLIANCE WITH CUSTOMER'S INSTRUCTIONS

[**362] The Respondents submitted that, in certain instances, the Banks should be disentitled to indemnification because of a failure to comply strictly with the instructions of their customers. I am unable to give effect to this argument. It confuses the principle of strict compliance with documentary credits and the principle of strict compliance by the issuing Bank with the instructions of its customer.

[**363] The Respondents submit that there is a discrepancy between a portion of the form of letter of credit attached to the customer's "Application and Agreement for Irrevocable Standby Letter of Credit" (the Applications and the Letter of Credit as issued, with respect to the date of the Letter of Credit. This pertains particularly to the Hongkong Bank of Canada Letters of Credit, with the exception of those issued at the instance of Hugh and Marjorie Hendrie. [*173]

[**364] The customer's signed Application is in a "fill in the boxes" format, and requests the Bank to issue an irrevocable standby letter of credit for the account of the customer, in favour of the beneficiary,

in a stipulated currency for a stipulated amount and until a stipulated expiry date. In a box entitled "Type of Standby Letter of Credit" the words "Refer to attached" have been inserted. In the following box, which contains a space for the applicant to fill in "the exact wording to appear on the statement to be presented [by the beneficiary at the time of the call], the words "as per the attached form" are inserted.

[**365] The "attached form" is that of a letter of credit, containing the pertinent details and conditions, and in particular the words:

All drafts must be marked "drawn under Hongkong Bank of Canada, Toronto, Ontario, Canada Standby credit No. [number inserted), dated 11Dec90 " (underlining added)

[**366] In the operative instrument -- which is the cable sent by Hongkong Bank of Canada to its confirming bank, the Hongkong and Shanghai Banking Corp. in London, and forwarded to the beneficiary -- the comparable specific instructions referred to a date [*174] of December 21 , 1990, however. They read:

All drafts must be marked "drawn under Hongkong Bank of Canada, Toronto, Ontario, Canada standby credit No. [number inserted] dated 21Dec90. " (underlining added)

[**367] The sight drafts presented by the Society and Council of Lloyd's for payment conformed to the language of the operative instrument, but not to the precise language stipulated in the form attached to the customer's Application.

[**368] It is an important part of the law regarding letters of credit both that the documents presented by the beneficiary for payment comply strictly with the terms of the letter of credit, and that the Bank conform with the instructions of its customer. These principles involve two different sets of contractual relationships, however. The first pertains to the relationship between the issuing Bank and the beneficiary; the second to that between the issuing Bank and its customer.

[**369] The law is clear that there must be strict documentary compliance with the terms and conditions of the letter of credit in the tendered documents: Bank of Nova Scotia v. Angelica- Whitewear [1987] 1 S.C.R. 59, at pp. 94-100. [*175] While some American courts -- but not the majority -- have flirted with a rule of substantial documentary compliance, Mr. Justice LeDain made it clear in Angelica-Whitewear , supra , that those in the U.K. and Canada have not, although he left room for "some latitude for minor variations or discrepancies that are not sufficiently material to justify a refusal of payment" (p. 96). At p. 94 he stated: The fundamental rule is that the documents must appear on their face, upon reasonably careful examination, to be in accordance with the terms and conditions of the letter of credit. This appears from Article 7 of the Uniform customs (1962) ... and Article 8 (now Articles 15 and 16a of UCP 400) ... There must be strict compliance with the terms and conditions of the letter of credit. This rule has been laid down in a number of English cases and followed in Canada ...

[**370] LeDain J. then proceeded to cite with approval the frequently quoted passage from Equitable Trust Co. of New York v. Dawson Partners. Ltd. (1926), Ll. L. Rep 49 (H of L), where Viscount Sumner said, at p. 52: It is both common ground and common sense that in such a transaction the accepting bank can only [*176] claim indemnity if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.

[**371] As I have pointed out, however, the principle of strict documentary compliance concerns a comparison between the documents tendered to the issuing Bank by the beneficiary for payment and the terms and conditions of the letter of credit itself. In the instances in question here there was such compliance, because the operative instrument -- the cable or telex from Hongkong Bank of Canada to the Hongkong and Shanghai Banking Corp -- contained the same instructions and language as were incorporated into the sight draft which was presented for payment. The doctrine [*177] of strict documentary compliance, therefore, does not assist the Respondents in this case.

[**372] What about the principle of compliance by the Bank with the instructions of its customer, though ? The banking witnesses all acknowledged that compliance with the customers' instructions was a fundamental tenet with respect to matters relating to letters of credit. Some even used the phrase "strict compliance".

[**373] While it is clear that an issuing bank must comply with its customer's instructions, the law in this respect, in my view, is not as strict -- if I may use that word in this context -- as it is with respect to the principle of documentary compliance. In this area, when the cases refer to "strict compliance" with a customer's instructions they are referring to the same sort of documentary compliance between the instructions, as set out in the letter of credit , and the language of the presented documents. In terms of the customer's instructions, themselves, instead of referring to "minor variations" the cases refer to "ambiguities": see, Midland Bank Ltd. v. Seymour , [1955] 2 Lloyds Rep. 147, at pp. 151 and 153; Commercial Banking Co. [*178] v. Jalsard [1973] A.C. 279 (P.C.) at pp. 285-286. In the former case, Devlin J. stated: The question in this case, as I see it, is what, upon the true construction of the letter of credit, were the instructions which the bank received that it had to comply with ... (p. 151)

... In my judgment, no principle is better established than that when a banker or anyone else is given instructions or a mandate of this sort, they must be given to him with reasonable clearness. The banker

is obliged to act upon T, them precisely. He may act at his peril if he disobeys them or does not conform with them. In those circumstances there is a corresponding duty cast on the giver of instructions to see that he puts them in a clear form. Perhaps it is putting it too high for this purpose to say that it is a duty cast upon him. [Emphasis start] The true view of the matter, I think, is that when an agent acts upon ambiguous instructions he is not in default if he can show that he adopted what was a reasonable meaning.[Emphasis end] (p. 153)
(emphasis added)

[**374] In Commercial Banking Co. v. Jalsard , supra , Lord Diplock expressed a similar view in these terms (pp. 285-286):

It is a [*179] well-established principle in relation to commercial credits that if the instructions given by the customer to the issuing banker as to the documents to be tendered by the beneficiary are ambiguous or are capable of covering more than one kind of document, the banker is not in default if he acts upon a reasonable meaning of the ambiguous expression or accepts any kind of document [Emphasis start] which fairly falls within the wide description used.[Emphasis end] (emphasis added)

[**375] There is a discrepancy between the specific wording stipulated in the draft form of letter of credit attached to the Respondent Hongkong Bank customers' Applications for the letters of credit and the comparable stipulation in the operative Letters of Credit itself. The discrepancy apparently arises because the Applications were made on December 11, 1990 whereas the Letters of Credit in question were not actually issued until December 21st. The Letters of Credit did not become effective until of January 1, 1991. In my view, the discrepancy created an ambiguity of application. On the facts, the Bank acted reasonably in dealing with it.

[**376] The Letters of Credit, as issued, contained all of [*180] the pertinent terms and conditions, as set out in the customers' Applications, including a reference to the correct number for the Letter of Credit. Indeed, had the Bank inserted the date of the Application into the operative instrument, rather than the date of the issuance of the Letter of Credit, it would have created an even more dangerous ambiguity -- a reference to a letter of credit which did not exist, that is, one issued on December 11th. Instead, the Bank complied strictly with the Instructions of its customers, in the sense that it issued Letters of Credit in the terms and conditions set out in the customers' Applications, reasonably resolving an ambiguity created in those instructions by ensuring that the operative instrument accurately reflected those terms and conditions of the credit which was being issued.

[**377] In addition, the terms of the Applications themselves provide that "in consideration of [the Bank] issuing a Standby Letter of Credit substantially in accordance with the foregoing application . Applicant acknowledges and agrees to be bound by the Terms and Conditions appearing on the reverse side of this Application" (underlining added). The Letters of [*181] Credit issued were "substantially in accordance" with the terms of the Application, in my opinion.

[**378] Thus, this argument fails the Respondents as well.

[**379] The beneficiary of the Letters of Credit was the Society and Council of Lloyd's. It was also submitted that the Banks failed to give effect to the principles of documentary compliance and the necessity of following their clients' instructions by honouring sight drafts payable instead to the Corporation of Lloyd's. Additional fuel for this argument was drawn from the provisions of the Underwriting Members' Security Agreement between the Names and the **Society of Lloyd's,** which calls (in paragraph 3) for any sums received by the Society in satisfaction of the Name's covenant to be held in trust by the Society.

[**380] It is true that the sight drafts which were presented to the Banks for payment named the payee as The Corporation of Lloyd's, in Trust for the Name in question. Whether that constitutes a breach of the underlying contractual structure between the Names and the **Society of Lloyd's** is not a matter of concern for the issuer of a letter of credit, however, given the principle of the autonomy of letters [*182] of credit. Absent fraud, the Bank need only be concerned with the sufficiency of the documentation presented. By virtue of Article 55 of the Uniform Customs and Practice for Documentary Credits, No. 400, the beneficiary is entitled to assign the proceeds of the letter of credit. Mr. Wickremeratne, who has more than 40 years experience in the area, testified that this provision of the UCP permits the beneficiary to ask the Bank to pay whomever it wants. I accept this evidence, although it is merely confirmatory of what the aforesaid provision of the UCP independently permits the beneficiary to do, in my opinion.

C. LETTERS OF CREDIT vs. LETTERS OF GUARANTEE

[**381] Their contractual arrangement with the **Society of Lloyd's** required each Name to post security for his or her deposit obligation by way of either a letter of credit or a letter of guarantee. Whichever option was selected, the document was to be in the form approved by Lloyd's.

[**382] There is a significant difference between a letter of credit and a letter of guarantee, of course. The latter is much more favourable to the Name because it permits many more defences to be raised in the event of a claim. The former, [*183] in the case of a standby letter of credit such as those in issue here, as we have seen, requires no proof of loss on the part of the beneficiary of the credit -- although it is triggered by such a loss -- and, in the absence of fraud, is payable simply upon presentation to the Bank of a sight draft in the proper form.

[**383] A letter of credit creates an autonomous contractual obligation between the issuer and the beneficiary of the credit which is completely independent of the contractual obligations as between the

beneficiary and the issuer's customer. It also creates a reciprocal contractual obligation between the issuer and its customer. These obligations are direct. A guarantee, on the other hand, is a secondary obligation, with respect to which the liability of the guarantor is dependent first upon the liability of the principal obligor. See K. McGuinness, The Law of Guarantee (Carswell, 1986), at pp. 386-387.

[**384] It was submitted that, notwithstanding the foregoing, a standby letter of credit is tantamount to a letter of guarantee because its purpose is to guarantee the performance of an obligation. The standby letter of credit should therefore be treated as a [*184] guarantee, so the argument went. The argument, however, is not tenable at law.

[**385] It is the choice of the instrument, not its purpose, which determines whether the principles that apply to letters of credit are to be associated with its use: see, Gordon B. Graham and Benjamin Geva, Standby Credits in Canada , Vol. 9 Canadian Business Law Journal (1984) 180, at pp. 195 and 213; Westpac Banking Corporation v. The Duke Group Limited (in Liquidation) et al., supra , at pp. 524-525. Although they had the option to choose a letter of guarantee, it is clear from their evidence that the Respondents instructed the Banks to provide letters of credit in the form required by Lloyd's.

[**386] Mr. Justice Farley dealt with the distinction between a standby letter of credit and a guarantee, and reviewed the authorities at some length, in Westpac Banking , supra . He concluded that "a standby letter of credit is critically different from a guarantee or indemnity" (p. 525). I agree. See also, In re Carley Capital Group; Beach v. First Union National Bank of North Carolina , 119 B.R. 646 (W.D. Wis. 1990); 885676 Ontario Ltd. (Trustee of) v. Frasmet Holdings Ltd. (1993), 12 O.R. (3d) 62 [*185] (Ont. C.J., Gen. Div.), at p. 68.

[**387] Farley J. cited the following passage from McGuinness, The Law of Guarantee , supra , at pp. 386-387:

Because the obligation under the letter of credit is separate and distinct from that of the underlying transaction, the obligation assumed by the issuer under the letter of credit cannot be viewed as being in the nature of a guarantee. A guarantee is a secondary obligation with the liability of the guarantor being governed by the liability of the principal. In a guarantee, the surety undertakes to indemnify the creditor against loss arising from the non- payment or non-performance of the principal. A letter of credit transaction does not involve indemnification. under a letter of credit, the issuer enters into an undertaking to pay upon presentation of documents. Although a letter of credit relates to another transaction, the obligations assumed by its issuer are not of a secondary nature but are independent – they have a life of their own that is separate from the life of the underlying contract. The amount payable under the letter of credit is not dependent upon proof of damage by the beneficiary. It is this factor, known as the autonomy [*186] of the credit, which most clearly distinguishes a letter of credit from a guarantee.

... while standby credits are closely analogous to guarantees, there are two key features which distinguish such credits from guarantees First, under a standby letter of credit, the issuer is liable as a principal rather than as surety. Second, standby credits differ from guarantees in that, as in the case of all letters of credit, payment becomes due upon compliance with the terms of the credit (that is, upon presentation of appropriate documentation) rather than because of the act of default itself.

[**388] See also Sarna, Letters of Credit: The Law and current Practice (3rd ed., 1989 updated 1993), at p.17.

[**389] This is not the end of the matter insofar as the distinction between letters of credits and letters of guarantee is concerned for the purposes of these proceedings, however. While it is clear from the testimony of those Respondents who took the stand, and from the witness statements/affidavits of those who did not, that the Respondents asked the Banks to issue letters of credit, there is confusion in some of the indemnity documentation in this regard.

[**390] With respect [*187] to the Royal Bank Respondents, except for Dr. Laird Jennings, each Letter of Credit that was issued was accompanied by a signed Indemnity Agreement in favour of the Bank which refers on its face to a letter of guarantee rather than to a letter of credit. Dr. Jenning's Indemnity Agreement refers to a letter of credit. in each instance, the Indemnity Agreement states, in part:

In consideration of your issuing at the request of the undersigned a Guarantee, a copy of which appears on the reverse hereof , the undersigned hereby agrees to repay to you on demand all amounts that you may pay pursuant to the said Guarantee ... (italics added)

[**391] While the reference is to a guarantee, however, what appears on the reverse thereof , in each case, is a duplicate of the letter of credit which has been issued on behalf of the particular Respondent. Which did the parties intend to be the operative document giving rise to the right to indemnity -- a guarantee, or the attached letter of credit ? In considering this question, given the ambiguity arising from this conflict, I am at liberty to consider not simply the wording of the Indemnity document itself, but evidence of the circumstances [*188] surrounding its execution -- the factual matrix in which that took place together with other evidence of the parties, although not direct evidence of their intention: Chitty on Contracts , 25th ed., paragraphs 765-766, 802, 818 and 819. No Respondent even suggested that he or she had asked the Bank to issue anything other than a letter of credit. I have no trouble in concluding - and I do -- that the parties intended the Indemnity to refer to the Letter of Credit, the duplicate of which was attached, and not to a letter of guarantee.

[**392] In any event, this issue is determined in favour of the Bank, in my view, by the terms of the Uniform Customs and Practice for Documentary Credits (1983 Revision), No. 400, to which each of the Letters of Credit is stipulated to be subject. Article 16a of UCP 400 states:

If a bank so authorized effects payment ... the party giving such authority shall be bound to reimburse the bank which has effected payment ...

[**393] This provision constitutes a contractual obligation, separate and distinct from that set out in the Indemnity agreement, to reimburse the Bank when payment otherwise authorized has been made. In my opinion it obligates [*189] the Respondents to reimburse the Banks for payments duly made by them to the beneficiary.

D. CHANGE IN TEE TERMS OF THE LETTERS OF CREDIT UPON THE TRANSFER FROM LLOYDS BANK CANADA TO HONGKONG BANK OF CANADA

[**394] Lloyds Bank Canada initially issued the Letters of Credit in favour of the Respondents Anne Hendrie, Ian Taylor, Thomas Parrott, Jane and William Perrin, Sean McDonough and Edward Reynolds. When Lloyds Bank Canada was acquired by Hongkong Bank of Canada, the latter Bank issued letters of credit to replace the Lloyds Bank credits. When this occurred, there were two changes made in the conditions which governed the credits, as between the Bank and the customer.

[**395] Both changes, as it happens, favoured the customer, but the Respondents affected argue that, no matter, the changes were not discussed with them and they therefore vitiate the Respondent's obligations to reimburse the Bank: a change in terms without the approval of the customer constitutes a failure to comply with the customer's instructions, it is said.

[**396] The changes in question are: (i) a change in the applicable interest rate to a rate more favourable to the customer, and (ii) a change in [*190] the clause concerning the place of the applicable law, which in substance did not amount to any change. All of the affected Respondents, except for Mr. Parrott, signed a Hongkong Bank Application, however. The Application contains the new terms in issue. They cannot say they were not aware of them, or that they are not bound by them, in my view. None of the changes had any prejudicial or negative impact on any of the Respondents. In any event, they -- Mr. Parrot included -- are obligated to reimburse the Bank by virtue of the independent contractual obligation to that effect, contained in UCP 400, Article 16a, and set out above.

[**397] The Applicant Banks are entitled to reimbursement from the Respondents for amounts paid pursuant to the draws on the Letters of Credit. This entitlement is based both upon the provisions of Article 16a of UCP 400, recited above, and upon the contractual terms binding the Banks and the Respondents. I shall not review the contractual arrangements in detail. Each Respondent either executed a separate Indemnity Agreement (the Royal Bank Respondents) or signed an Application for Credit which contained an obligation to indemnify and reimburse the Bank [*191] for payments made (Hongkong Bank and Citibank). There is some variation in language, but the thrust of the obligation to indemnify and reimburse the Bank in the event that the Letter of Credit is called upon is the same.

E. DOUBLE COUNTING

[**398] Finally, it was argued that there are serious questions regarding the quantum of Lloyd's losses, and therefore, about the quantum of the Respondents' obligations to Lloyd's. It is alleged that many of the Lloyd's losses are fictitious, that the true losses are unknown, and that the Chief Executive officer of Lloyd's (Peter Middleton) has acknowledged this to be the case.

[**399] There was very little evidence at trial with respect to this issue, but in any event it does not assist the Respondents on the letter of credit question, in my opinion. issues with respect to quantum and accounting are issues that exist between the Respondent customer and the beneficiary of the Letter of Credit, the Society and Council of Lloyd's. They are exactly the sort of issues pertaining to the underlying transactions which, in the absence of fraud, the letters of credit transcend.

PART V

CONCLUSION

[**400] For all of the reasons outlined above, [*192] then, the Applicant Banks are entitled to succeed in these proceedings. Judgment will accordingly issue in their favour for the relief claimed in their respective Notices of Application, as follows:

1. WITH RESPECT TO HONGKONG BANK OF CANADA

[**401] a)a declaration that the payments made under the following letters of credit issued by Hongkong Bank of Canada were properly made:

[**402] (i)Letter of Credit S000517 in the amount of GBP 76,000, issued at the request of Thomas N. Parrott;

[**403] (ii)Letter of Credit S000528 in the amount of GBP 115,500, issued at the request of Anne Hendrie;

[**404] (iii)Letter of Credit S000532 in the amount of GBP 140,000, issued at the request of Ian Taylor;

[**405] (iv)Letter of Credit S000537 in the amount of GBP 42,000, issued at the request of Anne Hendrie;

[**406] (v)Letter of Credit S000510 in the amount of CAD $547,200.00, issued at the request of Hugh S. Hendrie;

[**407] (vi)Letter of Credit S000511 in the amount of CAD $547,200.00, issued at the request of Marjorie I. Hendrie;

[**408] (vii)Letter of Credit S000529 in the amount of GBP 54,000.00, issued at the request of Sean McDonough;
[**409] (viii)Letter [*193] of Credit S000534 in the amount of GBP 91,000.00, issued at the request of Jane A. Perrin;
[**410] (ix)Letter of Credit S000538 in the amount of GBP 126,000, issued at the request of Sean McDonough;
[**411] (x)Letter of Credit S000539 in the amount of GBP 175,000, issued at the request of William E. Perrin;
[**412] (xi)Letter of Credit S000532 in the amount of GBP 140,000, issued at the request of Edward R. Reynolds.
[**413] b)a declaration that Hongkong Bank of Canada is entitled to reimbursement from the aforesaid Respondents (except the Respondent Edward R. Reynold, a bankrupt) in an amount equal to the Canadian dollar equivalent of all amounts paid under the aforesaid Letters of Credit, plus interest pursuant to their respective Letters of Credit;
[**414] c)an order requiring the aforesaid Respondents (except the Respondent Edward R. Reynolds, a bankrupt) to pay Hongkong Bank of Canada the amounts together with the interest referred to in subparagraph 1(b) above; and,
[**415] d)costs of the proceedings.
2. WITH RESPECT TO CITIBANK CANADA
[**416] a)a declaration that the payment made under Letter of Credit No. 39036 (formerly 88CSG-CL3009) issued by [*194] Citibank Canada at the request of the Respondent Jacqueline M. Levin in the amount of GBP 70,000, was proper;
[**417] b)a declaration that Citibank Canada is entitled to reimbursement from the Respondent Jacqueline M. Levin in the Canadian dollar equivalent of all amounts paid under the said Letter of Credit, plus interest pursuant to the said Letter of Credit;
[**418] c)an order requiring the Respondent Jacqueline 14. Levin to pay Citibank Canada the amounts together with the interest referred to in subparagraph 2(b) above; and,
[**419] d)costs of the proceedings.
3. WITH RESPECT TO THE ROYAL BANK OF CANADA
[**420] a)a declaration that Royal Bank of Canada was contractually and legally obliged and bound to honour draws upon the following Letters of Credit issued by it at the request of the following Respondents:
[**421] (i)Letter of Credit No. ST 2/45446, issued on December 8, 1987 at the request of Peter J. Clarke, and drawn in the amount of 70,000 by The Society and Council of Lloyd's on November 9, 1992;
[**422] (ii)Letter of Credit No. SB 2642/36955, Issued on November 17, 1986 at the request of Murray O'Neil, and drawn in the amount of 192,471.23 by [*195] The Society and Council of Lloyd's on November 9, 1992;
[**423] (iii)Letter of Credit No. SB 6802/30799, issued on November 19, 1985 at the request of William D. Darlington, and drawn in the amount of 66,615.12 by The Society and Council of Lloyd's on April 15, 1993;
[**424] (iv)Letter of Credit No. SB 6/6680, issued on November 9, 1982 at the request of William T. Gaukrodger in favour of the Committee of Lloyd's, and drawn in the amount of 86,213.35 by the Committee of Lloyd's on April 26, 1993;
[**425] (v)Letter of Credit No. SB 6012/57476, issued on March 28, 1989 at the request of G. Gordon Symons, and drawn in the amount of 36,683.52 by The Society and Council of Lloyd's on June 4, 1993;
[**426] (vi)Letter of Credit No. SB 3502/37129, issued on November 28, 1986 at the request of Ian C. Munro, and drawn in the amount of CAD $46,307.97 by The Society and Council of Lloyd's on June 4, 1993;
[**427] (vii)Letter of Credit No. SB 1822/36958, issued on November 17, 1986 at the request of Laird Jennings, and drawn in the amount of 182,000 by The Society and council of Lloyd's on August 27, 1993;
[**428] (viii)Letter of Credit No. SB 1822/43480, issued on September [*196] 23, 1987 at the request of Peter Palmer, and drawn in the amount of 180,000 on October 13, 1993.
[**429] b)an order declaring that the aforesaid named Respondents are each obliged to pay to Royal Bank of Canada an amount equal to the Canadian dollar equivalent of the amount paid by Royal Bank of Canada in respect of the draws upon their respective Letters of Credit, together with interest at the rate of Royal Bank's prime rate plus 1% from the date upon which the respective draws were paid; and judgment for the said sums; and,
[**430] c)costs of these proceedings.
[**431] If there are outstanding issues with respect to the accurate amounts of the monies to be paid by the Respondents by way of reimbursement, as counsel indicated at the close of argument there might be, I may be spoken to in that regard.

[**432] I am prepared to fix the scale and quantum of costs, if the parties are unable to agree upon them. written submissions may be made in that regard, if necessary, within 30 days of the release of these Reasons.

[**433] In closing, I should like to express my appreciation to all counsel for the skill and clarity with which they each presented their clients, cases. [*197] I am grateful to them for their assistance in this complex and difficult matter.

SCHEDULE "A"

[**434] The following is a summary of the Letters of Credit issued to the Respondents and which are at issue in these proceedings:

CITIBANK CANADA

Respondent/Name	Date L/C Opened	Amount	Date Called
Jacqueline Levin	**June 16/87**	**70,000**	**December 20/93**

HONGKONG BANK OF CANADA

Respondent/Name	Date L/C Opened	Amount called	Date Called
Anne Hendrie	**December 21/90**	**27,000**	**November 6/92**
December 21/90	**3,232**	**November 6/92**	
December 21/90	**80,839**	**July 16/93**	
Hugh Hendrie	**November 20/90**	**C$547,200**	**October 11/93**
Marjorie Hendrie	**November 15/90**	**C$462,444**	**Sept. 6/93**
Ian Taylor	**December 21/90**	**140,000**	**November 6/92**
Thomas Parrott	**December 21/90**	**35,844**	**April 13/93**
Jane Perrin	**December 21/90**	**46,890**	**June 27/91**
44,110	**October 11/93**		
William Perrin	December 21/90	55,665	July 8/91
119,335	October 11/93		
Sean McDonough	December 21/90	126,000	October 11/93
December 21/90	54,000	October 11/93	
Edward Reynolds (Bankrupt)	December 21/90	140,000	November 6/92

ROYAL BANK OF CANADA

Respondent/Name	Date L/C Opened	Amount Called	Date Called
Peter Clarke	**December 6/87**	**70,000**	**November 6/92**
Murray O'Neil	**November 17/86**	**192,471**	**November 6/92**
62,529	**August 11/93**		
William Darlington	**November 19/85**	**66,616**	**April 15/93**
William Gaukrodger	**November 9/82**	**86,213**	**April 28/93**
Ian Munro	**November 28/86**	**C$46,308**	**June 3/93**
Gordon Symons	**March 28/86**	**36,683**	**June 3/93**
Laird Jennings	**November 17/86**	**182,000**	**August 26/93**
Peter Palmer	**September 23/87**	**180,000**	**October 11/93**

[*198]

[**435] In all cases except that of Dr. Gaukrodger, the beneficiary of the letter of credit is The Society and council of Lloyd's. The named beneficiary of Dr. Gaukrodger's Letter of Credit is The Committee of Lloyd's. Only those Letters of Credit on which calls have been made, and paid, are listed above. Others were issued at the request of various of the Respondents. The amounts of the calls have been rounded to the nearest pound or dollar.

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