Finance Alert

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Second Circuit Reverses Ruling, Says Mistaken $500 Million Wire Transfer Paying Off Revlon Loan Must Be Returned

Recipients of an erroneous $500 million wire transfer that had the financial world buzzing must return the funds, a U.S. Court of Appeals for the Second Circuit panel held on Sept. 8, reversing a New York federal district court ruling.

In 2020, Citibank N.A. erroneously transmitted the funds to loan managers for certain lenders on a $1.8 billion seven-year syndicated loan to Revlon Inc. The $500 million error paid off Revlon's outstanding principal balance three years before the company's loan repayment was due. Citibank, the administrative agent for the lenders, asked the lenders to return the funds. While a number of the lenders participating in the syndicate did return the funds received upon Citibank's request, some refused. In a suit filed by Citibank to seek the return of the erroneous payments, the district court ruled that the lenders did not need to return the money—a ruling that caused great concern within the financial community. As a consequence, administrative agents and the lawyers representing them began including in credit agreements express "erroneous payment" language, which required lenders to return erroneous payments to the administrative agent.

Recently, the Second Circuit determined that the lower court erred in deciding the loan managers did not have to return the money. The "discharge-for-value" rule did not in fact shield the loan managers from Citibank's restitution claims because they were on inquiry notice of the mistake, wrote Judge Pierre N. Leval in an opinion joined by Judges Robert D. Sack and Michael H. Park. Judge Park also wrote a separate concurrence.

The circumstances around the erroneous transfer showed red warning flags that would have prompted "a reasonably prudent person" who faced an avoidable risk of loss to look into whether the transfer resulted from a mistake. Further, a reasonable inquiry would have revealed the mistake, said the panel.

How It Happened

While transmitting accrued interest to the lenders' loan managers on Aug. 11, 2020, Citibank made an error that caused the accidental wire transfer of $894 million—the full amount of Revlon's outstanding principal balance—three years before Revlon's loan repayment was due.

Despite three people having reviewed and approved the transaction before it was executed, the transmission was sent without certain specific settings that would have prevented the principal balance from being wired. The transaction occurred at a time when, because Revlon was insolvent, loan participations were trading at 20% to 30% of the face amount. (Revlon later filed for Chapter 11 bankruptcy, on June 15, 2022.)

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Citibank discovered the erroneous transmission the next day and issued a total of four recall notices over the next few days, requesting that the loan managers return the portion representing the principal. However, certain loan managers, representing $500 million in debt, refused to return the funds.

Discharge-for-Value Rule

Citibank sued those loan managers in the U.S. District Court for the Southern District of New York. Following a bench trial, the district court concluded that the rule of discharge-for-value protected the loan managers from Citibank's restitution suit, relying on *Banque Worms v. BankAmerica International.*

In *Banque Worms*, the New York Court of Appeals upheld a lender's right to retain a bank's mistaken repayment to the bank's client of a loan that was due and payable. The Court of Appeals based its ruling on the American Law Institute's discharge-for-value rule, published at Section 14 of the Restatement (First) of Restitution (Am. Law Inst. 1937). The discharge-for-value rule outlines circumstances that excuse the recipient of a payment mistakenly made in discharge of a debt due, from the obligation to return the mistaken payment.

The district court ruled that the loan managers were entitled to keep the funds that Citibank had mistakenly paid. It concluded that the defendants established the elements of the discharge-for-value defense because (1) the lenders were creditors of Revlon on the date of the mistaken payment, (2) each lender was owed in principal and interest the exact amount of money it received from Citibank, (3) neither the lenders nor the loan managers made misrepresentations to induce the mistaken wire transfers, and (4) neither the lenders nor the loan managers were on notice of Citibank's mistake.

On appeal to the Second Circuit, Citibank raised several arguments challenging the discharge-for-value rule and the applicability of *Banque Worms* to this case.

Constructive Notice

Citibank argued the loan managers could not claim the benefit of the discharge-for-value rule because they were on notice of a mistake.

The panel agreed. Under New York law, the discharge-for-value rule does not shield the beneficiary of a mistaken transfer from claims for restitution if the beneficiary is on inquiry notice of the mistake. Further, based on the facts available to the loan managers on Aug. 11, the standard of inquiry notice was satisfied. "The facts were sufficiently troublesome that a reasonably prudent investor would have made reasonable inquiry and reasonable inquiry would have revealed that the payment was made in error," the panel wrote.

The loan managers were aware of four red warning flags that suggested a mistake:

1. The absence of prior notice of a prepayment, to which the lenders were contractually entitled.
2. The inability of the insolvent Revlon to make a repayment of close to $1 billion.
3. The fact that the loan was trading at 20 to 30 cents on the dollar, so it could have been retired far more cheaply than by paying its full value.
4. Revlon's attempt just four days earlier to avoid acceleration of the loan's maturity by making an exchange offer to holders of the 2021 notes.

Further, the district court's ruling depended on its factual findings that the loan managers believed in good faith that the payments they received were not a mistake and on its conclusion that those beliefs were reasonable. The panel said the district court's reasoning represented a misunderstanding of the inquiry notice test.

"The test is not whether the recipient of the mistaken payment reasonably believed that the payment was genuine and not the result of mistake. The test is whether a prudent person, who faced some likelihood of avoidable loss if the receipt of funds proved illusory, would have seen fit in light of the warning signs to make reasonable inquiry in the interest of avoiding that risk of loss," it explained.

Reasonable Inquiry

Citibank also challenged the district court's conclusion that a reasonable inquiry would not have revealed the mistake. The panel again sided with Citibank. In this case, calling Citibank would have been an easy and obvious way to confirm any suspicion that the wire transfer payment was a mistake. A loan manager who failed to

call Citibank or Revlon but relied instead on nothing more than confirming that the payment matched the debt did not conduct a reasonable investigation, the panel said.

Having failed to make those calls, the loan managers were chargeable with notice of what they would have learned. Therefore, the panel concluded, the loan managers were on notice of Citibank's mistake and were thus ineligible to claim the discharge-for-value defense.

Banque Worms Ruling

The panel also agreed with Citibank's contention that the loan managers were not protected by the *Banque Worms* ruling because on Aug. 11, they were not entitled to the money they received from Citibank, since Revlon's debt was not yet payable.

The plaintiff in *Banque Worms* was entitled to the money because the loan at issue was payable and the defendant demanded payment. The loan in this case was not payable for three more years, the panel explained. The *Banque Worms* decision highlighted the finality of wire transfers, but it did not give a higher value to finality over all other values.

On the contrary, the *Banque Worms* court explicitly left standing New York's basic rule requiring the return of the mistaken payments except where identified exceptions apply. It also provided exceptions to the denial of restitution based on factors such as when the transferee made misrepresentations or had notice of the mistake, said the panel.

Additional Comments

Judge Leval wrote an addendum to the opinion, questioning whether an accidental payment of the kind made by Citibank comes within the scope of the Restatement's discharge-for-value rule.

The Restatement rule applies in circumstances where the transferor's payment resulted from his "mistake . . . as to his interests or duties." Citibank was not mistaken as to its interests or duties. Its only mistake was making a wire transfer setting error, said Judge Leval. Therefore, the discharge-for-value rule has no application to the payment made in this case, which was an accidental payment made without intent to pay, without intent to discharge a debt or lien and without mistake as to the transferor's duties or interests, he said.

Judge Park wrote a concurrence in which he said he agreed only with the judgment. The district court clearly erred in concluding that there were insufficient red flags to put the loan managers on notice of Citibank's mistake. However, the loan managers' case failed on a more basic level, he said.

The recipient of mistakenly transferred funds cannot invoke the discharge-for-value defense "unless and until it has a present entitlement against the debtor." In other words, the recipient can't keep the money sent by mistake unless it is entitled to it anyway, said Judge Park.

Related Professionals

Anthony Pirraglia . . . . . apirraglia@loeb.com
Peter G. Seiden . . . . . pseiden@loeb.com