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Just Under the Wire:

LOAN AGENT ENTITLED TO RECLAIM $500M MISTAKEN *REVLON* PAYMENT

By George H. Singer

Electronic funds transfers are a way of life. The banking industry in fact wires an estimated $5.4 trillion each day. And mistakes happen, particularly in a digital age. How does the law deal with mistaken payments?

> *"When people receive money by mistake, the law usually requires them to give it back. This common sense rule allows transferors to reclaim property that rightfully belongs to them—whether misdirected funds, an accidental overpayment, or a credit to the wrong bank account."*[1]

The Court of Appeals for the Second Circuit recently ruled that the administrative agent for lenders on a $1.8 billion syndicated loan to Revlon Inc. that accidentally wired $500 million of its own money to lenders was entitled to recover the payment. The Second Circuit in *Citibank, N.A. v. Brigade Capital Management, LP et al.*,[2] overturned the district court's decision that allowed the lenders who received funds the agent mistakenly wired as an unintended early repayment of the loan to keep the funds.

Factual Background

Citibank, N.A., acting as loan agent under a syndicated credit facility with cosmetics giant, Revlon, accidentally wired nearly $1 billion of its own money to lenders paying off the loan nearly three years early and at a time when the borrower was under financial distress. Citibank had no intention of making the payment discharging Revlon's debt. The payment was made unintentionally and by accident. Citibank had intended to only make a $7.8 million regularly scheduled, interest payment.

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[1] *Citibank, N.A. v. Brigade Capital Management, LP et al.*, 2022 US. App. LEXIS 2520 (2d Cir. Sept. 8, 2022) (C.J. Park, concurring in judgment) (citations omitted).

[2] 2022 US. App. LEXIS 2520 (2d Cir. Sept. 8, 2022).

The massive mistake was attributed to software problems and human error associated with a refinancing by Revlon of its debt. After Citibank made demands for repayment and approximately $400 million was eventually returned, the bank sued asset managers for those lenders that refused to return the funds. These lenders took the position that Citibank was a sophisticated bank and paid the lenders exactly what was owed.

District Court Bombshell

The district court conducted a bench trial and sided with the Revlon lenders. The court refused to allow the clawback by Citibank of the mistakenly wired funds even though the lenders were advised of the error the very next day.[3] The court applied the discharge-for-value rule under New York state law precedent that allows creditors to retain erroneously wired funds in situations in which they are owed money on a debt and are not on notice that a mistake has been made.[4]

The lower court found that the discharge-for-value rule required that lenders have *actual notice* that the payments were made in error. The district court ruled that the prepayment was a "discharge for value" and found that it would have been "borderline irrational" for the lenders, each of whom received exactly (to the penny) what was owed, to believe that the payment was anything other than a legitimate prepayment. The lenders did nothing to induce payment and were owed the debt.

Citigroup appealed the district court's decision.

Revlon Enters Bankruptcy

Citibank then sued Revlon in the bankruptcy court after it received the results of the district court order and Revlon sought bankruptcy protection. The

[3] The law generally treats the failure to return money mistakenly wired as conversion or unjust enrichment and requires the recipient to return the funds to the sender. *See generally,* U.C.C. § 4A-303 (governing payment by mistake and specifying that a bank that mistakenly wires more money than ordered by the sender is entitled to recover from the beneficiary of the erroneous order the excess payments received to the extent allowed by the law governing restitution and mistake).

[4] The "discharge-for-value" defense operates as an exception to the general rule under New York law: "When a beneficiary receives money *to which it is entitled and has no knowledge that the money was erroneously wired*, the beneficiary should not have to wonder whether it may retain the funds, rather such beneficiary should be able to consider the transfer of funds as a final and complete transaction, not subject to revocation." *Banque Worms v. BankAmerica Int'l*, 570 N.E.2d 189, 196 (N.Y. 1991) (emphasis added). *See* RESTATEMENT (FIRST) OF RESTITUTION § 14(1) (Am. L. Inst. 1937) (providing the discharge-for-value defense).

lawsuit is intended to cement Citibank's right to repayment and lender status in the bankruptcy proceedings.

The bank asserted that it became a creditor of Revlon, effectively stepping into the shoes of the Revlon lenders that received the erroneous payment and refused to return the funds. Citibank argued that the company should be ordered to reimburse the bank for what it could not recoup.[5] The bank argued that it was under no obligation or otherwise responsible for paying off Revlon's debt to non-returning lenders.[6] And failing to recognize the bank's rights as a creditor in the bankruptcy case would allow Revlon to effectively "escape liability for its own debt obligations."

Second Circuit Provides Relief

The Second Circuit recently found that the discharge-for-value rule only operates in favor of a recipient of a mistaken payment who was "entitled" to the money.[7] The debt needs to be presently "due" (not just outstanding). The lenders were not entitled to full repayment for another three years after Citibank erroneously wired them a half a billion dollars—a fact that was one of several red flags pointing to a mistake on Citibank's part. The discharge-for-value rule does not "shield" the beneficiary of a mistaken transfer from restitution if the beneficiary is on inquiry notice.

In reversing the district court's decision, the Second Circuit found that the discharge-for-value principle did not apply because the Revlon lenders were on *constructive notice* that the payment to them was in error. The presence of warning flags, including the prepayment of principle and Revlon's known efforts to restructure the debt, should have put a prudent lender on inquiry notice that the wiring was a mistake.[8] The red flags should have triggered an obligation on the

[5] Revlon filed for Chapter 11 bankruptcy protection on June 15, 2022 in the Southern District of New York and Citibank asserted rights and status as a secured creditor in the case by virtue of equitable subrogation or assignment of repayment rights of certain Revlon lenders.

[6] Citibank naturally took issue with any suggestion that Revlon might not be responsible, one way or another, for the mistaken loan payment and that almost 15% of Revlon's debt load was erased due to the erroneous payment: "Unsurprisingly, neither the Revlon Group nor any other party-in-interest had ever articulated any legitimate legal or factual basis for challenging Citibank's subrogation rights for inclusion in the DIP [Financing] Orders. . . . There is none."

[7] "Put simply, you don't get to keep money sent to you by mistake unless you're entitled to it anyway." *Citibank, N.A. v. Brigade Capital Management, LP et al.*, 2022 US. App. LEXIS 2520 (2d Cir. Sept. 8, 2022) (C.J. Park, concurring in judgment) (citations omitted).

[8] The "red flags" also included (1) the absence or prior notice from Citibank to the lenders of a prepayment, a requirement under the credit agreement; (2) the current discounted trading value of the Revlon loan; and (3) the known inability of

part of a reasonable lender to at least make a telephone call to loan agent that transferred the funds.

The court also found that the Revlon lenders were not shielded from Citibank's restitution claim as allowing them to keep the money would result in a "huge windfall." Such a result "would turn equity on its head and topple the settled expectations of participants in the multi-trillion-dollar debt market." It would simply be "brutally unfair."

The Second Circuit vacated the judgment and remanded to the district court for further proceedings consistent with the opinion which will presumably result in an order authorizing the reclamation by Citibank of the mistakenly transferred funds.

Implications

The Citibank case, while ultimately providing a huge sigh of relief for lenders and agents, highlights risks in the banking industry. Citibank's procedures required three people to sign off on a transaction of this size before it is executed, yet the error occurred when a subcontractor checked the wrong box on a digital payment form and principal of nearly $1 billion was sent out, not the $7.8 million in interest that was intended. The fight for the return of the funds lasted for years before rectified by the Second Circuit. If the lower court ruling, were allowed to stand, there would be little recourse available against recipients for a mistaken payment if the amount paid is actually owed in the absence of clear contractual protections between the parties—even if not due until years later and there was no intention of paying at that time.

The importance of having adequate safeguards and procedures in place when a business makes or receives electronic payments cannot be emphasized enough. Regular checks and re-checks of technology and risk management systems are pivotal. As the lower court observed, banks and other electronic payors are in the best position to avoid mistakes in the first place: "a mistake such as occurred here can be effectively held to a minimum through the utilization of 'commercially reasonable' security procedures in effecting wire transfers."[9] A failure of a party who is most able to avoid the error may ultimately result in that party being forced to bear the risk of any associated loss.

While lenders need to continue to be vigilant and maintain sufficient controls to prevent errors resulting in mistaken payments and act quickly upon

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Revlon to make the payment; and (4) steps Revlon had taken to avoid acceleration of the loan. The non-returning lenders were aware of Revlon's apparent deep insolvency—evidence presented revealed that the lenders believed at the time that Revlon "was insolvent by as much as $1.71 billion."

[9] *In re Citibank August 11, 2020 Wire Transfers*, Case No. 20-CV-6539 (JMF) (S.D.N.Y. Feb. 15, 2021) (quoting *Banque Worms*, 928 F.2d at 197), *rev'd*, 2022 US. App. LEXIS 2520 (2d Cir. Sept. 8, 2022).

discovery of a mistake, the legal standard established by the Court of Appeals provides some welcome relief for erroneous payments. Contracts should nevertheless be evaluated to ensure that adequate protections are included to deal with mistakes, particularly in transactions using electronic payments. The inclusion of language in credit agreements addressing the consequences of mistaken payments and right of the loan agent to recover such payments, for example, remains advisable in order to return the parties to their respective position in the event of an error as if it did not occur.

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