SEPTEMBER 15, 2022

Citibank Gets Its Money Back

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A February 16, 2021 decision of the United States District Court for the Southern District of New York held, in *In re Citibank August 11, 2020 Wire Transfers*, 520 F. Supp. 3d 390, that lenders who received almost $900 million mistakenly wired to them by Citibank (the administrative agent for a $1.8-billion syndicated seven-year term loan to Revlon [2016 Loan]) were entitled to keep the money. See our bulletin A One-in-a-Billion (-Dollar) Mistake, in which we describe the decision. The United States Court of Appeals for the Second Circuit has now reversed that decision.

The District Court Decision

The District Court had held that the lenders were protected by a doctrine known as the "discharge-for-value" defence. Under New York law, a creditor does not have to return mistakenly paid funds that discharged a debt owed to them if the creditor (i) was unaware and did not have notice (which could include constructive as well as actual notice) of the mistake at the time it received the payment, and (ii) made no misrepresentation to the debtor that it was required to make the payment. The District Court had relied on the leading New York case on this defence, *Banque Worms v Bank America Int'l*, 570 N.E.2d 189 (N.Y. 1991). In that case, the New York Court of Appeals (the highest New York State appellate court) said, at 196:

> "When a beneficiary received 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 funds; rather, such a beneficiary should be able to consider the transfer of funds as a final and complete transaction, not subject to revocation."

The District Court had found that, under New York law, the lenders did not have constructive notice of Citibank's mistake for various reasons, including the following:

- The amounts wired were the exact amounts that would have been owed had Revlon decided to prepay the loans in full.
- Since Revlon had been engaged in negotiations to restructure its debt, it was not unreasonable for lenders to believe that it must have decided to prepay this facility.
- While the credit agreement required Revlon to provide three days' written notice of prepayment to Citibank, which Citibank was in turn required to provide to each lender "promptly" after its receipt, it was not uncommon for such notices not to be received by lenders before the actual prepayment itself, or never to be sent at all.
- Calculation statements provided to the lenders stated that interest payments were "due," and since the payment was not made on a scheduled interest payment date, there was only one way in which interest would have been due, which was with prepayment of the full principal. Separate statements were often sent for the principal component, so that the reference only to interest did not put the lenders on notice of a probable error.

The U.S. Court of Appeals Decision

The U.S. Court of Appeals drew different inferences from the facts than the District Court, holding that the lenders did have constructive notice of Citibank's error, applying the "inquiry notice standard" under New York law (as distinct from a standard of "knew or should have known"): "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 Court of Appeals found that the lenders "were aware of four red warning flags consisting of facts suggestive of accident or mistake" – namely,

- "the absence of prior notice of a prepayment, to which the Lenders were contractually entitled";
- "the apparent inability of the insolvent Revlon to make a near $1 billion repayment";
- "in view of the fact that the 2016 Loan was trading at 20-30 cents on the dollar, it could have been retired far more cheaply than by paying its full value";
- "Revlon's elaborate contrivance only four days earlier to avoid acceleration of the 2016 Loan made no sense if Revlon was planning to retire that debt a few days later."

The Court of Appeals noted that the inquiry notice standard is an objective one: "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." While the Court of Appeals does not explicitly suggest that the lenders engaged in wilful blindness, the Court's repeated references to the lenders' failure to call Citibank to inquire about the correctness of the payments suggest such a suspicion.

The Court of Appeals further held that the *Banque Worms* principle did not apply because the lenders were not "entitled" to the funds, since the loan was not due for another three years. This requirement reflects that the discharge-for-value defence is a specific application of protecting a bona fide purchaser for value without notice. The Court noted that it is generally contrary to the principles of restitution to allow the recipient of a mistaken payment to retain a windfall when it has not detrimentally changed its position in reliance on the payment. Since Revlon filed for Chapter 11 bankruptcy on June 5, 2022, the windfall nature of the lenders' receipt of full prepayment of their loans is rather obvious.

Canadian Implications

In our previous bulletin, we noted that the New York discharge-for-value defence has not been recognized under Canadian law, and it is unclear how a Canadian court would address facts similar to those in the *Citibank* decision. Canadian law also has not developed a clear standard comparable to the New York inquiry notice standard for what constitutes constructive notice that a payment has been made by mistake. However, on similar facts, a Canadian court could very well reach the same result as the Court of Appeals in New York on the grounds that no debt was due and owing to the lenders in respect of the principal of the loan, the lenders did not rely to their detriment on the mistaken payments, and the suspicion that the lenders deliberately refrained from asking Citibank any questions.

"Revlon Clawback" Clauses

As we suggested in our previous bulletin, both in the United States and Canada, it is now common for credit agreements to include "Revlon Clawback" clauses. In the agency provisions of a credit agreement, typically the lenders will expressly promise to return to the agent payments made in error and waive any defence to the agent's claim to repayment. The borrower will agree that such mistaken payments do not discharge its obligations and that the agent is subrogated to the rights of the lenders to the extent that the agent does not recover any such payments.

The reversal of the *Citibank* decision is unlikely to change the practice of including these provisions in loan documents. Their effectiveness has not been tested in any court case to date, and since errors of the magnitude made by Citibank are presumably rare, they may never be.

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