Clients&FriendsMemo

When "Six Eyes" Just Aren't Enough

February 25, 2021

On February 16, 2021, the United States District Court in the Southern District of New York (the "Court") issued a decision *In Re Citibank August 11, 2020 Wire Transfers*[1] that upheld the "discharge for value" doctrine and ruled that certain lenders (the "Defendants") were entitled to retain funds erroneously sent by the administrative agent (the "Plaintiff") under a credit facility to which the Defendants were a party. The decision largely relied upon the application of the facts in this case to precedent established in a 1991 New York Court of Appeals case (*Banque Worms v. BankAmerica International*)[2] involving a mistaken wire transfer of $2 million.

Background

Defendants and other lenders were party to a $1.8 billion dollar syndicated loan originated in 2016 (the "2016 Term Loan"). On August 11, 2020, five lenders (the "Roll Up Lenders") under the 2016 Term Loan exercised their rights under the 2016 Term Loan documents to exchange their positions in the 2016 Term Loan for another credit facility with Revlon, Inc. (the "Borrower") under the 2016 Term Loan (the "Roll-Up Transaction"). Due to technical limitations in the Plaintiff's back-office systems, the Borrower agreed to pay accrued interest to 2016 Term Loan lenders (*e.g.,* the Defendants and the Roll-Up Lenders), even though the Defendants were not participating in the Roll-Up Transaction.

1 *See* U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF. Beginning on August 17, 2020, Citibank, N.A. filed three separate suits against the Defendants, claiming unjust enrichment, conversion, money had and received, and payment by mistake. Following each of the three filings, the Court issued temporary restraining orders preventing the Defendants from transferring or disposing any of the wired funds in dispute. The Court subsequently consolidated all three cases. *See* August 19, 2020 and August 21, 2020 Orders, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF. Dkt. Nos. 28, 35. Upon the consent of all parties, the Court consolidated the hearing on a motion for a preliminary injunction with trial on the merits and extended the temporary restraining orders through the date of the trial. *See* August 19, 2020 Order, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. Nos. 28; *see also* September 30, 2020 Order, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. No. 94.

2 *See Banque Worms v. BankAmerica Int'l*, 570 N.E. 2d 189, 192 (N.Y. 1991).

The easiest method for Plaintiff to effectuate the Roll-Up Transaction was to enter it into Flexcube[3] as a full payoff of the 2016 Term Loan, which would thereby trigger the accrued interest payments to all lenders for the 2016 Term Loan while directing the principal payment to an internal wash account for internal cashless fund entries. Because the vast majority of the Plaintiff's wire transactions involve payments to third parties, any payment entered into Flexcube is automatically released as an external wire transfer unless this default option is overridden. The wire transfers associated with the Roll-Up Transaction were subject to Plaintiff's standard "six-eye" approval procedure.[4] Despite the "six eye" approval process, the default option for principal payments was not properly suppressed when executing the wire transfer, which resulted in both the interim interest and principal payments (made up of Plaintiff's own funds) being sent to Defendants and the Roll-Up Lenders in amounts matching the outstanding principal owed to each lender to the exact penny on August 11, 2020.

The error was discovered the following day on August 12, 2020 and Plaintiff distributed recall notices to each lender beginning the next afternoon informing the lenders that the principal payments were released erroneously and requesting return of the principal. While a portion of the 2016 Term Loan lenders did return the erroneous payments, Defendants refused to remit the funds. Following such refusal, Plaintiff brought four claims against them, including conversion, unjust enrichment, money had and received, and payment by mistake.

Analysis

In ruling against Plaintiff with respect to each claim, the Court relied on the common law "discharge-for-value" rule promulgated by *Banque Worms*. The rule, as established in the Restatement (First) of Restitution,[5] provides that "a creditor of another or one having a lien on another's property who has received from a third person any benefit in discharge of the debt or lien, is under no duty to make restitution therefor, although the discharge was given by mistake of the transferor as to his interests or duties, if the transferee made no misrepresentation and did not have notice of the transferor's mistake."

The initial point of contention between the parties with respect to the applicability of the defense was whether it only applies when a debt is "due". The Plaintiff argued that, because the related

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3 Flexcube is a software application and loan product process program used by the Plaintiff to initiate and make wire payments. See *In Re Citibank August 11, 2020 Wire Transfers*, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. No. 243, p. 10.

4 Plaintiff's "six-eye" approval procedure requires three people to review and approve a transaction before it is executed. The "maker" inputs the payment information into Flexcube, then the "checker" then reviews and verifies the transaction before the "approver" conducts a final check on the maker and checker's work. See *In Re Citibank August 11, 2020 Wire Transfers*, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. No. 243, p. 10.

5 *See* RESTATEMENT (FIRST) OF RESTITUTION § 14(1) (AM. LAW INST. 1937).

principal payments were not then due (only outstanding), the Defendants could not avail themselves of this defense. The Court concluded that the language within the Restatement (First) of Restitution makes it clear that the rule applies to any bona fide creditor with no qualifications with respect to the payment schedule or maturity date of the debt. As such, Defendants met the first prong of the discharge-for-value test as a bona fide creditor under the 2016 Term Loan.

The second disputed point was whether or not the Defendants had notice of the transferor's mistake, which can be broken down into two separate issues: first, at what point in time the Plaintiff's party's notice is to be evaluated and second, whether actual or constructive notice is required.

With respect to the first point, Plaintiff argued that the court must evaluate the notice at the point in time in which the payment was applied to the debtor's account to discharge the debt,[6] not upon receipt of the wire. Plaintiff argued that if notice was evaluated at the time of receipt then an immediate discharge of debt would occur upon every mistaken payment given the immediacy of wire transfers which would not allow the recipient any chance to even suspect error, nor would it allow any transferor time to notify the recipient of their error. In relying upon precedent[7] and common law, the Court found that unless notice of the transferor's error preceded the receipt of the funds, not the application of funds to the debtor's account to discharge the debt, a creditor was entitled to treat the funds as an irrevocable payment of the outstanding debt.

As to what type of notice is required, the Court ruled that only constructive notice is required.[8] The Court concluded Defendants had no constructive notice of the error given that (a) the mistaken payments included the exact amount of outstanding principal owed to each lender,[9] (b) neither the

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6 Note that the Court found that while each Defendant retained the money, none of them actually applied the funds to the debtor's account. Additionally, each Defendant had a different internal procedure for processing the payment. This highlighted the Court's finding that promoting Plaintiff's interpretation of the notice requirement would result in a burdensome and fact-intensive inquiry. *See In Re Citibank August 11, 2020 Wire Transfers*, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. No. 243, p. 52-54.

7 *See Banque Worms v. BankAmerica Int'l*, 726 F. Supp. 940 (S.D.N.Y. 1989), *aff'd sub nom. Banque Worms v. BankAmerica Int'l*, 928 F.2d 538 (2d Cir. 1991) (holding that "any awareness by [Banque Worms] of [Security Pacific's] mistake two hours after the funds were transferred by wire *[wa]s not material*.") (emphasis added); *see, e.g.*, *M'Crea v. Purmort*, 16 Wend. 460, 474 (N.Y. 1836 ("The payment of the money discharges or extinguishes the debt; a receipt for the payment does not pay the debt, it is only evidence that it has been paid.")).

8 *See Qatar Nat'l Bank v. Winmar, Inc.*, 650 F. Supp. 2d 1, 10 (D.D.C. 2009) (concluding that "the discharge-for-value rule applies only if [the recipient] did not have actual or constructive notice before [it] credited [the debtor's] account."; *In re Calumet Farm, Inc.*, 398 F.3d 555 (6th Cir. 2005) (holding that "[a]ny sensible application of the discharge-for-value rule…must account for constructive as well as actual notice of a mistake."); *see also* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 69 (AM. LAW INST. 2011).

9 The Court noted that if the amounts received by each Defendant were off by even a decimal point, then the Defendants would have had reason to view the transfer as a "fat finger" mistake, rather than a prepayment. Additionally, there was not a single witness for either party that could recall an instance in which a bank had accidentally wired the exact amounts owing

Plaintiff nor the syndicated loan market had a consistent process for notifying lenders of any full or partial prepayments,[10] and (c) it was reasonable for Defendants to view the transfer of funds as a full principal prepayment rather than a "black swan event" error.

Conclusion

The case highlights the fact that payors are in the best position to avoid errors in the high stakes world of wire transfers and are the appropriate party to bear the risk of any associated losses. There is no substitute for ironclad internal wire procedures. Industry leaders will need to re-evaluate their approval processes to ensure there are fail safes in place should a similar situation arise. Lenders and administrative agents may consider incorporating a claw-back provision for any erroneous payments into their loan origination and servicing documents. The Court also suggested that the syndicated loan market would be well served to establish clear and consistent standards governing prepayment notices. In this instance, the administrative agent, by virtue of the payment to the Defendants is now effectively a lender of such funds to Revlon together with the balance of the syndicate member lenders who returned the mistaken funds to the Plaintiff. It is important to note that while the Plaintiff did not intend to transfer the approximately $900 million (net approximately $500 million after giving effect to the returned funds) to the Defendants, the transfer did not discharge Revlon. To the extent that the Plaintiff is not successful on appeal, it could try to re-syndicate this debt, however this may prove to be quite difficult as this case arose out of a refinance to a distressed company. Should such re-syndication prove unsuccessful, the Plaintiff will be left holding a $500 million exposure to this borrower which it was not prepared to incur.

We will keep you apprised of future developments, if any, on this case.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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on outstanding loans. *See In Re Citibank August 11, 2020 Wire Transfers*, U.S. District Court for the Southern District of New York Case No. 1:20-cv-06539-JMF, Dkt. No. 243, p. 66, 87.

[10] Judge Furman's opinion also noted that it was not uncommon for payment notices to arrive late, or to not be sent at all. Multiple witnesses for the defense testified that it was not out of the ordinary for them to receive loan payments without any prior notice of such payment. Additionally, Plaintiff's own expert witness noticed that he would not be surprised to see split notices for principal and interest payments arriving on different dates even if they detailed payments that were going to be made on the same date. *See Id.* at 82-83. The Court held that due to the lack of consistency with respect to prepayment notices, "a reasonable investor reviewing the Calculation Statements in this case would not have (and should not have) known upon later receiving the exact amount of principal and interest outstanding that the payment was by mistake." *See Id.* at 83.

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