Clients&FriendsMemo

Second Circuit Rules in Favor of Citibank in Accidental $500m Transfer in Revlon Loan Transaction

September 28, 2022

In a decision rendered September 8, 2022, a three-judge panel for the United States Court of Appeals for the Second Circuit (the "Court") vacated a February, 2021 decision by the United States District Court for the Southern District of New York in favor of the defendant loan managers of certain institutional lenders (the "Loan Managers"),[1] which held that the Loan Managers were not obligated to return an accidental payment by Citibank N.A. ("Citi") of approximately $500 million.[2] Citi served as administrative agent to the lenders for an $1.8 billion syndicated seven-year loan to Revlon, Inc. ("Revlon") pursuant to a credit agreement entered into in 2016 (the "2016 Loan").

I. Background

As administrative agent, Citi was responsible for collecting interest and principal payments from Revlon and transmitting the same to the Loan Managers on behalf of the lenders (the "Lenders").[3] The outstanding principal and accrued interest for the subset of Lenders represented by the defendant Loan Managers was $558,558,375.74 as of August 11, 2020, Citi's mistaken payment date, and the 2016 Loan did not mature until September 7, 2023, subject to acceleration if any notes representing unsecured senior debt (specifically, those due in early 2021, the "2021 Notes") remained outstanding on November 16, 2020.[4]

In May 2020, Revlon needed to raise additional capital through a series of transactions (collectively, the "May 2020 Transaction"), which included entering into a credit agreement with a subset of the Lenders party to the 2016 Loan and amending the loan agreement to make certain collateral from

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1 The Loan Manager defendants include Brigade Capital Management, LP ("Brigade"), HPS Investment Partners, LLC ("HPS"), Symphony Asset Management LLC ("Symphony"), Bardin Hill Loan Management LLC ("Bardin Hill"), Greywolf Loan Management LP ("Greywolf"), ZAIS Group LLC ("ZAIS"), Allstate Investment Management Company ("Allstate"), Medalist Partners Corporate Finance LLC ("Medalist"), Tall Tree Investment Management LLC ("Tall Tree"), and New Generation Advisors LLC ("New Generation").

2 In re: Citibank August 11, 2020, Docket No. 21-487 (2nd Cir. 2022).

3 In re: Citibank, at 6.

4 *Id.* at 7.

the 2016 Loan secure the new loans.[5] In connection with the May 2020 Transaction, Revlon issued a senior secured loan facility of up to $815 million, for which it used (i) $65 million to repay a revolving credit facility, (ii) $246 million to pay outstanding principal, interest and other fees on a 2019 term loan and (iii) $112.8 million to repurchase and cancel a portion of the 2021 Notes.[6] Revlon also issued a certificate asserting its solvency to meet its liabilities as part of the May 2020 Transaction.[7] Disputes around the amendment to the loan agreement gave rise to litigation against Revlon and Citi, asserting a number of claims that emerged from the May 2020 Transaction, namely an allegation that Revlon was insolvent and faced a severe liquidity crisis, which was amplified by the COVID-19 pandemic.[8]

Four days prior to Citi's mistaken payment, on August 7, 2020, Revlon offered to exchange the 2021 Notes for new notes due in 2024, specifically to avoid acceleration of the 2016 Loan. Further, Revlon's disclosures related to this exchange made no mention of raising funds to pay off the 2016 Loan.[9]

On August 2, 2020, five of the Lenders managed by Angelo Gordon and Co. ("Angelo Gordon") were exchanging their interest in the 2016 Loan for a new Revlon credit facility as part of a roll-up transaction (the "Roll-Up Transaction"), where Revlon was to pay the exchanging Lenders interim interest accrued as of August 11, 2020 (the "Transfer Date"), the date of the Roll Up Transaction, and deliver notes for the principal amount of the new loan rather than the outstanding principal on the 2016 Loan. For administrative reasons, Revlon opted to pay accrued interest to all of the Lenders party to the 2016 Loan, although no interim interest was due to those Lenders not participating in the Roll Up Transaction. Such Lenders were not aware they would receive accrued interest on the Transfer Date because Citi did not notify the other Lenders of the Roll Up Transaction.[10]

To accomplish the Roll Up Transaction, Citi had to enter the transfer into its computer software application and loan processing program, as a full payment of the 2016 Loan. This triggered accrued interest payments to all Lenders and directed the principal portion to an internal Citi account used for internal entries to prevent money from leaving the bank.[11] On the Transfer Date, Citi made a clerical error, which caused the inadvertent wire transfer of the full amount of Revlon's

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5 *Id.* at 10.

6 *Id.* at 11.

7 In re: Citibank, at 12.

8 In re: Citibank, at 12-13.

9 *Id.* at 14.

10 *Id.* at 15-16.

11 In re: Citibank, at 16.

outstanding principal balance, approximately $894 million of Citi's own funds, at a time where the 2016 Loan was trading at 20-30 cents on the dollar.[12]

Although there were a number of steps to process the Roll Up Transaction, which was subject to review and approval by three Citi employees prior to execution, the reviewers all incorrectly believed that when entering the payment in the system, only one field was required to suppress wire transfer of the principal; however, the manual for the system provided that three fields must be set to the internal Citi account to suppress payment of a principal amount.[13] Citi also sent notice of the interest payment to the Lenders shortly before the payments themselves were received by the Lenders on the Transfer Date, which made no mention of any payment of principal.[14]

Citi recognized the error the following day and demanded return of the amount which represented the principal balance of the 2016 Loan.[15] Citi continued to send recall notices over the course of the next few days, stating that the funds belonged to Citi and the Lenders were legally obligated to return the principal as is standard practice when fund transfers occur mistakenly.[16] Managers who represented approximately 200 Lenders returned $385 million to Citi, but the defendant Loan Managers that represented 126 Lenders with roughly $500 million in debt refused to return the transferred funds.[17]

Citi brought suit for restitution bringing claims of unjust enrichment, conversion, money had and received, and payment by mistake against the defendant Loan Managers when they refused to return the amounts accidentally transferred.

Following trial in December 2020, the district court held the Loan Managers did not have to return the money based on the "discharge-for-value" rule (the "Discharge-for-Value Rule") of the American Law Institute's Restatement (First) of Restitution (the "First Restatement"), relying on *Banque Worms v. BankAmerica International*, 570 N.E.2d (N.Y. 1991) ("*Banque Worms*").[18] The general rule of New York law that governs mistaken payments requires the recipient to return the money, unless such requirement would be unjust because the recipient significantly changed their position in reliance on the mistake, taking it out of the general rule.[19] The district court in *Banque*

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[12] *Id.* at 18, 23.

[13] *Id.* at 18-19.

[14] *Id.* at 21-22.

[15] In re: Citibank, at 23-24.

[16] *Id.* at 25-26.

[17] *Id.* at 28.

[18] In re: Citibank, at 5 (citing August 11, 2020 Wire Transfers, 520 F. Supp. 3d (S.D.N.Y. 2021)).

[19] *Id.* at 34-35.

Worms established an exception to the general rule based on the Discharge-for-Value Rule, which provides that a creditor who has received a mistaken discharge of debt from a third party, is not required to repay such amount if the transferee did not make any misrepresentations and did not have notice of the transferor's mistake.[20]

Citi contended that (i) the Discharge-for-Value Rule only applies where the recipient is entitled to the funds, and in the instant matter, the Lenders were not entitled to the funds as the 2016 Loan was not payable for another three years, (ii) the Loan Managers did not receive value in satisfaction of the Discharge-for-Value Rule because they did not credit Revlon on their books after receipt of Citi's repayment of the 2016 Loan, and (iii) the Loan Managers had constructive notice, which qualifies as "knowledge" under *Banque Worms*, of the error.[21] The Court vacated the district court ruling, concluding that the Loan Managers (i) were on notice of Citi's error, and (ii) were not entitled to the money at the time of Citi's mistaken payment.[22]

II. Inquiry Notice Standard

The Court reasoned that both New York law and the First Restatement apply an inquiry notice standard, rather than one of "knew or should have known" as asserted by the defendants.[23] The applicable standard of the First Restatement provides that a person is on notice when they know facts that "would lead a reasonably intelligent and diligent person to inquire."[24] The defendant Loan Managers also argued that *Banque Worms* implicitly rejected an inquiry notice standard in stating that a recipient "should not have to wonder whether it may retain the funds", but the Court disagreed concluding there was no issue of notice for the Court to discuss in that case.[25] The Court held that the Discharge-for-Value Rule did not apply in the instant matter because the defendants were on inquiry notice that the unexpected early repayment of principal was due to a mistake, where the Loan Managers were aware of the following warning signs: (i) the lack of prior notice of a prepayment that Lenders were entitled to under the 2016 Loan, (ii) the clear inability of Revlon to make a repayment of the principal while insolvent, (iii) the 2016 Loan was trading at 20-30 cents on the dollar and could have been retired for cheaper than paying the entire face value of the debt, and (iv) four days before the Transfer Date, Revlon made an exchange offer to the holders

[20] In re: Citibank, at 37-38 (citing Restatement (First) of Restitution, § 14).

[21] *Id.* at 39-40.

[22] *Id.*

[23] *Id.* at 44.

[24] In re: Citibank, at 47 (citing Restatement (First) of Restitution, § 174)

[25] *Id.* at 50 (citing Banque Worms, 570 N.E.2d at 196).

of the 2021 Notes to avoid acceleration of the 2016 Loan, which would have been pointless if Revlon intended to voluntarily accelerate four days later.[26]

Inquiry notice is an objective test, which provides that when information available to the recipient of an apparent repayment includes facts that suggest a reasonable suspicion of error, the question is whether a reasonably prudent investor at risk of avoidable loss would have found the facts sufficient to warrant reasonable inquiry. If so, the recipient would be responsible for the knowledge that such reasonable inquiry would have revealed.[27] Weighing the factors cited by the district court that correctly support a reasonable belief that the payment was genuine against the factors that constitute red flags, the Court concluded a reasonably prudent investor who faced an avoidable risk of loss would have called Citi to inquire.[28]

The Court also held that if the Loan Managers had made such reasonable inquiry, it would have revealed that Citi's transfer was a mistake.[29] The district court concluded that reasonable inquiry would not have exposed the mistake and was persuaded by the fact that Citi's payment matched exactly to the penny the amount of outstanding principal and interest owed to each of the Lenders. The district court relied on the testimony of an expert witness and interpreted such testimony to mean that a reasonable inquiry could include third-party market data or wisdom, but not necessarily consulting the sender of the funds to confirm the payment was intentional.[30] The Court, however, reasoned that the fact that the payment exactly matched the amount of debt did not eliminate the four warning signs outlined above.[31]

A recipient who failed to call Citi or Revlon, but only relied on internally confirming that the payment matched the amount of debt, cannot be said to have conducted a reasonable inquiry.[32] When ascertaining that the payment matched the amount of debt failed to explain away the red flags, the inquiry notice test required them to take the simple further step of calling their agent, Citi. In failing to make that call, the Loan Managers were chargeable with notice of what they would have learned.[33]

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[26] *Id.* at 54-59.

[27] In re: Citibank, at 63-64.

[28] *Id.* at 76.

[29] *Id.*

[30] *Id.* at 77.

[31] In re: Citibank, at 79.

[32] *Id.* at 81-82.

[33] *Id.* at 82.

III. Entitlement to Payment

The Court agreed with Citi that the defendants could not rely on the Discharge-for-Value Rule because they were not entitled to receive repayment of the 2016 Loan on August 11, 2020.[34] The term "entitled" refers to a legal right, and a creditor has "[a] 'legal right' to funds loaned only when the debtor has an obligation to pay those funds."[35] Application of the Discharge-for-Value Rule here would leave the Lenders with a windfall, whereas restitution puts them in the precise position where they had contracted to be.[36]

The Court concluded that under New York law, a creditor may not implement the Discharge-for-Value Rule unless the debt at issue is immediately payable and vacated and remanded the district court judgment for further proceedings.[37] Ultimately, because the 2016 Loan was not due for three years after the Transfer Date, and the Loan Managers had constructive notice of the error, the defendants may not apply the Discharge-for-Value Rule as a defense against Citi's demand for restitution.

IV. Conclusion

While this decision rectifies a mistake made by Citi, the damage was done since it resulted in multiple years of litigation to recover hundreds of millions of dollars erroneously wired. When the original decision occurred, many lenders in the marketplace scrambled to overhaul their processes and procedures to prevent a similar occurrence and counsel to lenders reviewed and revised applicable provisions in loan documents to guard against a similar occurrence. The current decision seems to correct what was otherwise a "clerical" mistake. To the extent that this decision is appealed, we will continue to monitor 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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[34] *Id.* at 83.

[35] In re: Citibank, at 84.

[36] *Id.* at 90.

[37] *Id.* at 94.