ALERTS | 09.14.2022

Federal Appeals Court Rules Citibank Entitled to Recover $500m Erroneous Payment

In the wake of a Federal Appeals Court decision sure to be welcomed by the banking industry, Citibank will be allowed to recover hundreds of millions of dollars that it mistakenly paid out to a group of hedge funds. Although Citibank had only intended to make an approximately $8 million interest payment to certain lenders of Revlon, human error resulted in nearly $1 billion of Citibank's own funds being wired to Revlon's lenders in August 2020. The amount wired by Citibank included not only the interest that had come due, but also the full principal amount of the loan (the "Principal Repayment"). Lenders who received approximately $385 million agreed to return those funds to Citibank. However, a group of hedge fund-defendants (the "Defendants"), acting as managers for a subset of Revlon's lenders, refused to return funds totaling more than $500 million.

On February 16, 2021, the District Court for the Southern District of New York sided with the Defendants, holding that they were justified in keeping the Principal Repayment that they mistakenly received on account of New York's "discharge-for-value" doctrine. Then, on September 8, 2022, in an over-100 page opinion, a three-judge panel of the Second Circuit Court of Appeals vacated the District Court judgment and held that the "discharge-for-value" doctrine did not apply. The Second Circuit reached its conclusion based primarily on the "red flags" surrounding the Principal Repayment, which should have prompted further investigation by the Defendants and the fact that, at the time they received the funds, the Defendants were not entitled to recover the principal of the loan.

Beyond the question of whether the "discharge-for-value" doctrine should apply, the Second Circuit panel also focused on the equities of the case. The panel stressed that there would be "a huge windfall" for the Defendants who refused to return the mistaken Principal Repayment. Circuit Judge Michael Park concurred in the ruling, but maintained that the panel's lengthy analysis was not needed. Judge Park considers the case to have been "grossly overcomplicated." For him, the case is "straightforward": "Allowing [the Defendants] to keep that money would turn equity on its head and topple the settled expectations of participants in the multitrillion-dollar corporate-debt market."

Regardless of the complexity or simplicity of the decision, the Second Circuit uniformly decided that Citibank is entitled to recover the Principal Repayment that it mistakenly transmitted to its lenders.

Citibank Mistakenly Makes the Principal Repayment

Citibank was the administrative agent for the lenders to an approximately $1.8 billion, seven-year loan, issued to Revlon, Inc. in 2016 (the "2016 Loan"). Among other duties, Citibank was required to receive from Revlon, and transmit to the lenders, payments of principal and interest in accordance with the governing loan documents. The 2016 Loan was not due for repayment until September 2023.

Starting in the spring of 2020, Revlon entered into a series of restructuring transactions to access additional liquidity and refinance certain notes that were scheduled to mature in 2021. One of those transactions included Revlon entering into a new senior secured term loan facility. Certain of the lenders under the 2016 Loan elected to exchange their position in the 2016 Loan for positions in the new term loan facility via a "roll-up" transaction. Revlon was required to pay the exchanging lenders cash interest that had accrued as of the date of the exchange. For reasons of administrative convenience, Citibank elected to pay all lenders the accrued interest currently due on the 2016 Loan. Only those lenders who had elected to "roll up" their debt into the new term loan facility were aware of—and entitled to—the forthcoming interest payment.

The internal team at Citibank was tasked with wiring the interest payment to all holders of the 2016 Loan and reconstituting the 2016 Loan based on the participants who had elected the "roll up" option. Citibank never intended to make any payment to lenders under the 2016 Loan other than the cash interest payment. The Citibank team intended to wire the interest payment to all holders of the 2016 Loan and wire the principal amount of the loan to a "wash account" that would remain within the bank. Prior to sending the wires, Citibank sent each of its lenders a "Calculation Statement" providing that those lenders were to receive their pro rata share of the interest payment.

Citibank's internal team erred in transmitting the payment to Revlon's lenders. Based on a series of internal errors, in addition to the interest payment, the Principal Repayment that was to be sent to an internal "wash account" instead was wired to holders of the 2016 Loan. As a result of this error, the lenders received not only the interest payment to which they were entitled, but a prepayment of principal three years prior to maturity of the 2016 Loan.

Citibank sent a series of notices to the 2016 Loan lenders about the errant payment. Managers representing approximately 200 lenders honored Citibank's recall notice. However, ten Defendants that represent approximately 126 lenders refused to return the Principal Repayment that was erroneously transmitted. In response to their refusal, Citibank initiated a lawsuit seeking restitution for the mistaken Principal Repayment.

The District Court Allows the Defendants to Retain the Principal Repayment

The District Court allowed the Defendants to retain the Principal Repayment that Citibank mistakenly made after ruling that the Defendants had established the elements of "discharge-for-value" under Banque Worms v. Bank of America International, 570 N.E.2d. 189 (N.Y. 1991). The traditional rule under New York law governing mistaken payments generally requires restitution unless the recipient of the mistaken payment so significantly changed its position in reliance on the mistake that it would be unjust to require the recipient to make restitution.

In Banque Worms, the New York Court of Appeals endorsed an exception to this general rule. There, a bank that was acting on behalf of its customer (Spedley Securities), wired nearly $2 million to Banque Worms to repay the loan that Worms had extended to Spedley. Spedley's instruction to its bank came after Worms demanded repayment of the loan that was due and payable at the time of its demand. Spedley changed its mind and sent a countermanding instruction to its bank that the payment be made to a different payee. In its confusion, the bank paid Worms, who then refused to return the funds.

In the ensuing litigation, the New York Court of Appeals applied the "discharge-for-value" rule as set forth in Section 14 of the First Restatement of Restitution. The Banque Worms court explained that the recipient of a mistaken transfer of funds should be allowed to treat such transfer as a final and complete transaction, not subject to revocation, so long as the recipient "receives money to which it is entitled and has no knowledge that the money was erroneously wired." 570 N.E.2d at 196.

Applying the Banque Worms exception to the Citibank transfer, the District Court concluded that the Defendants were creditors of Revlon who received the exact amount of money that they were owed in both principal and interest. The District Court also found that the Defendants were not on notice of Citibank's mistake and did not make any misrepresentation to induce the Principal Repayment.

The Second Circuit Vacates the District Court's Judgment

Despite what it characterized as "the district court's impressive and scholarly handling of the case," the Second Circuit reached a contrary conclusion as to the application of the Banque Worms exception. The Second Circuit concluded that Citibank is entitled to prevail under New York law because (i) the Defendants had constructive notice of Citibank's error, and (ii) the Defendants were not entitled to the Principal Repayment at the time they received the funds.

The Second Circuit first focused on the proper notice standard under New York law. The Court concluded that the proper standard is inquiry notice and, under the facts surrounding Citibank's error, a reasonably prudent person should have made further inquiry. Such inquiry, had it been made by the Defendants, would have revealed that the Principal Repayment was made in error.

The Court discussed at length the "visible red flags" surrounding the Defendants' receipt of the Principal Repayment. The Second

Circuit, unlike the District Court, concluded that these red flags would cause a reasonably prudent person to inquire as to whether the transfer resulted from a mistake. Specifically, the Second Circuit focused on: (1) the absence of a prior notice of prepayment, which Citibank was contractually obligated to make; (2) the apparent inability of a "deeply insolvent" Revlon to make a near $1 billion repayment of its loan; (3) the fact that the 2016 Loan was trading at 20-30 cents on the dollar and thus could have easily been retired far more cheaply than by paying the full face-value of the loan; and (4) Revlon's exchange offer from a few days prior that it launched to avoid acceleration of the 2016 Loan.

Unlike the Second Circuit, the District Court did not believe that these "red flags" added up to notice of the mistake. Instead, what the District Court found most convincing was the fact that Citibank's payment exactly matched the outstanding principal plus accrued interest. The District Court found that, in such a scenario, even where the payment is unexpected, "it is reasonable to assume that the borrower has intentionally paid off the debt. In fact, it might even be unreasonable to assume otherwise."

The Second Circuit diverged from the District Court's conclusions after ruling that those conclusions depended on errors of law primarily involving the application of the inquiry notice test. The District Court relied heavily on its factual findings that the Defendants had a good faith belief that their receipt of the Principal Repayment was not the product of a mistake and, furthermore, that such beliefs were reasonable. The Second Circuit, however, rejected the notion that the subjective good faith beliefs of the Defendants mattered. Instead, the Second Circuit applied an objective standard to conclude that a reasonably prudent person should have inquired into the circumstances surrounding the Principal Repayment. Many money managers had, in fact, made such an inquiry and, upon learning of the error, returned the money to Citibank. The Second Circuit therefore concluded that the Defendants were on constructive notice of the mistake and thus not entitled to claim the "discharge-for-value" defense.

Having charged the Defendants with being on notice of the mistake, the Second Circuit further found that the Banque Worms exception did not apply because the Defendants were not entitled to receive the Principal Repayment. The District Court had accepted the Defendants' argument that they were entitled to the Principal Repayment because Revlon was contractually obligated to repay the 2016 Loan.

However, the Second Circuit focused on "present entitlement" to repayment. Because the Defendants were not entitled to repayment in full for another three (3) years, the Second Circuit reasoned that they were not "entitled" to receive the Principal Repayment. As such, the Defendants were not able to claim the "discharge-for-value" defense with respect to the payment. To allow them to do so would bring the Defendants "a huge windfall over and above what they bargained for, while an order of restitution would leave them exactly where they contracted to be."

Conclusion

As noted above, Circuit Judge Park concurred in the Second Circuit's judgment, but did so after describing the dispute as "a straightforward case that many smart people have grossly overcomplicated." Judge Park would have ended the inquiry based on the fact that the Defendants had no present entitlement to the Principal Repayment.

However, in concluding the Second Circuit's opinion, Circuit Judge Leval, writing only for himself, noted that the Court's lengthy decision may have precedential value in future disputes over whether a recipient is entitled to retain a mistaken payment. By vacating the District Court's judgment, the Second Circuit has made clear that common sense and equity should rule the day – a party who mistakenly receives a payment from its agent to which it is not entitled is unlikely to be allowed to retain that payment. Despite the import of the Second Circuit's decision, we believe that erroneous payment clauses, which have become fixtures in credit agreements since the District Court originally ruled in favor of the Defendants, are not going away.

Printable version.

Sean M. Monahan
Head of Sports Financing

Jonathan D. Marshall
Head of Independent Director & Special Committees