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# US Column: A “Black Swan” event

David Conaway reports on the recent New York Federal Court ruling that lenders are entitled to keep $500 million mistakenly paid by Citibank

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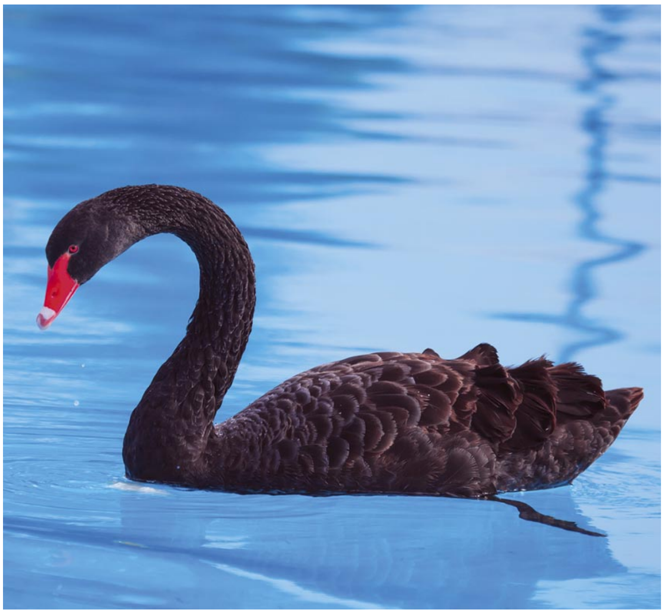

“Due to “human error”...in addition to the interest payments... the principal amount owed was mistakenly transferred to the lenders, not to the “Wash” account”

**In the context of a series of complex re-financings and roll-up transactions by Revlon in May and June, 2020, human error caused a $500 million loss for Citibank.**

On 16 February 2021, in the case of *In re Citibank August 11, 2020 Wire Transfers*, a New York Federal District Court ruled that Revlon lenders who mistakenly received approximately $500 million in payments from Citibank do not have to return the funds. Revlon authorised Citibank to make interest payments to the lenders totalling $7.8 million. Instead, Citibank made wire transfers that paid the loans (which were due in 2023) in full in the amount of about $894 million. Some of the lenders returned about $393 million, upon demand by Citibank. However, 10 lenders, which were investment advisory firms, refused to return $500 million that was paid to them.

In 2016, Revlon entered into a seven-year term loan agreement for $1.8 billion with a maturity date of 7 September 2023 (the “2016 Term Loan”). Citibank is the administrative agent for the loan. Pursuant to the loan agreement, Citibank’s duties included receiving funds from Revlon and making payments to the lenders.

In May and June, 2020, Revlon’s liquidity was “extremely tight”, precipitating Revlon securing $800 million of “new financing”. The May/June, 2020 debt facility was for $1.7 billion. Also, the 2016 Term Loan was modified to move certain collateral from the 2016 Term Loan to the 2020 debt facility. The “non-returning lenders” opposed this “siphoning” of collateral.

As a result of the new debt facility and the amendments to the 2016 Term Loan, Revlon authorised Citibank to pay interest to all of the 2016 Term Loan lenders in the amount of $7.8 million. Citibank contracted with Wipro Limited, an entity based in India, who used the Flexcube software application and loan product processing program to initiate and execute wire transfers for Citibank.

The easiest and perhaps only way to make the contemplated interest only payments was to enter the transaction as a loan payoff thereby triggering the accrued interest payment amount. There would be two kinds of transfers, one for the interest payments and a dummy principal payment, sent by wire transfer to a “Wash” account owned by Citibank. The funds for the principal payment were to never leave Citibank. This transaction was subject to Citibank’s “six-eye” approval procedure requiring three people to approve a transaction before the wire transfers would be initiated and executed.

## Human error

Due to “human error” in “checking” and “unchecking” the appropriate boxes in the Flexcube software application, in addition to the interest payments, on 11 August 2020, the principal amount owed was mistakenly transferred to the lenders, not to the “Wash” account.

Beginning on 12 August 2020, Citibank sent numerous “Recall Notices” to the lenders demanding return of the mistakenly paid funds. Some lenders complied. The "non-returning lenders" did not. On 17 August 2020, Citibank filed a lawsuit against such lenders alleging unjust enrichment, conversion (taking of another's property) and payment by mistake.

The New York court ruled in favour of the "non-returning lenders" based upon the "discharge-for-value" exception to restitution claims, which provides that a creditor has no duty to make restitution for a mistaken payment if the creditor made no misrepresentation and did not have notice of the transferor's mistake (The Restatement (First) of Restitution, American Law Institute 1937). The court concluded that the evidence was clear that the "non-returning lenders" did not know the payments were a mistake, noting particularly that the payoffs were to the penny.

*The Restatement (First) of Restitution*, adopted by the American Law Institute in 1937, sets forth the classic formulation of the discharge-for-value defense. To the extent relevant here, Section 14 of the *Restatement* explains the defense as follows:

> *"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 therefore, 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."*

## Disputed issues

In the Citibank litigation, there were three disputed issues regarding the discharge-for-value defence:

(1) Whether the obligation paid must be "due" or "owed",
(2) Whether the defendants' lack of knowledge of the mistaken payment occurs when the payment is made, or when it is credited, and
(3) Whether an actual or constructive notice is required.

Citibank argued that the discharge-for-value exception only applies to debts that are due, not including the 2016 Term Loan with a 2023 maturity.

The Court sided with the lenders that the obligation must only be owed, not due, based on the language of the *Restatement* defense. The Court further concluded that the relevant point in time of the defendants' knowledge of the mistaken payment was at the time of payment, which was prior to the time of the Recall Notices by Citibank. Finally, the Court concluded the constructive notice is the only sensible notice standard for the discharge-for-value defense.

## Witness testimony

Based on witness testimony by representatives of each of the defendants, the Court concluded that all the defendants believed that the payments were an intentional full pay-down of the outstanding principal and interest of the 2016 Term Loan. The Court was persuaded by the facts that the pay-downs were to the penny, that a sophisticated bank such as Citibank would have effective internal controls to avoid Black Swan significant mistakes, and that payments of interest before it is due implies a loan pay-off.

The Court found that the defendants' belief that the payments were intentional loan pay-offs was corroborated by Citibank's witness testimony and by the documentary evidence. Interestingly, the Court's opinion included the "quite colourful" Bloomberg chat among the defendants' employees:

*"I feel really bad for the person that fat fingered a $900mm erroneous payment. Not a great career move"*

*"certainly looks like they'll be looking for new people for their Ops group"*

*"How was work today honey? It was ok, except I accidentally sent $900mm out to people who weren't supposed to have it"*

*"Downside of work from home. maybe the dog hit the keyboard"*

*(the song "Had a Bad Day" playing the background)*

The Court noted importantly that there was no such communications among the defendants' employees *before* the Recall Notices were delivered, which supports the defendants' lack of any knowledge that the payments were mistaken under the discharge-for-value defense.

> *The defendants' belief that the payments were intentional loan pay-offs was corroborated by Citibank's witness testimony and by the documentary evidence*

“The defendants' belief that the payments were intentional loan pay-offs was corroborated by Citibank's witness testimony and by the documentary evidence”

## Black Swan event

The court also noted that a mistaken payment of this magnitude (and under Revlon's financial circumstances) was so improbable that it was a "Black Swan" event, citing Nassim Nicholas Taleb's "*The Black Swan: The Impact of the Highly Improbable*", a 36-week New York Times best-seller (and worth the read).

Citibank filed a Notice of Appeal on 26 February 2021.

It will be interesting to see if Citibank steps into the shoes of the "non-returning lenders" under the doctrine of equitable subrogation, or may assert claims for recovery against Revlon for unjust enrichment or various contract claims including for indemnification under the 2016 Term Loan agreement. Citibank recently filed its 10-K with the SEC, indicating as a result of the Court ruling, it now has "rights as a creditor related to the Revlon loan". For sure, administrative agent fees will increase, loan agreements will be modified and more insurance will be purchased to hedge against future "Black Swans". ■