BANKRUPTCY LAW ALERT
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The Second Circuit Saves Citibank from $500 Million Error and Clarifies What Constitutes Inquiry Notice in the Process

On September 8, 2022, the Second Circuit Court of Appeals held that a payment of nearly half a billion dollars made to lenders in error could be recovered by Citibank because the lenders were on "inquiry notice" that the payment was, in fact, a mistake. While bailing out Citibank from its blunder, the Court articulated a clear definition of "inquiry notice" under New York law. *Citibank, N.A. v. Brigade Cap. Mgmt., LP*, No. 21-487, 2022 WL 4102227 (2d Cir., 2022).

In 2016, Revlon obtained a $1.8 Billion syndicated, secured loan with Citibank, N.A. acting as administrator. Four years later, as Revlon faced significant financial distress, an interest payment in the amount of $7.8 Million became due. Nevertheless, Revlon transferred the $7.8 Million interest payment to Citibank to disburse to the lenders. Wipro Limited, a contractor for Citibank, inadvertently transferred approximately $894 Million dollars to the lenders, representing the total principal amount outstanding (which was not due for another three years). Shortly after discovering the mistake, Revlon and Citibank recovered roughly $385 Million, less than half of the mistaken payment.

Six days after the mistaken payment, Citibank sued the lenders that refused to return the funds seeking recoupment of the remaining monies, alleging unjust enrichment, conversion, money had and received, and payment by mistake.

The District Court ruled that the defendants were entitled to retain the funds under the "discharge-for-value defense." This doctrine, defined in *Banque Worms v. BankAmerica International,* 77 N.Y.2d 362 (1991), provides that a creditor that receives a mistaken payment in discharge of a debt may retain those funds, so long as the recipient did not induce the payment via misrepresentation, or have notice of the transferor's mistake. Relying on *Banque Worms*, the District Court held that the defendants were not on "constructive notice" of the mistake.

On appeal, the Second Circuit reversed the District Court's decision. Writing for the Court, Judge Pierre N. Leval noted that the traditional rule in New York regarding mistaken payments requires restitution of the funds to the payer, unless the recipient had significantly changed its position in reliance on the payment, such that restitution would be "unjust."

Judge Leval further noted, it is a "well-recognized principle of law" that a party who makes a payment based on a mistake of fact to a party who is not entitled to the funds, is entitled to restitution of that money.

In response to the *Banque Worms* "discharge for value" exception to the traditional rule, Judge Leval held that "discharge-for-value" does not apply if the recipient of a mistaken payment was on "constructive notice" of the mistake. Notably, Judge Leval held that under New York law, constructive notice is essentially equivalent to inquiry notice.

The Court went further, defining inquiry notice and explaining that the inquiry notice test examines whether a "hypothetical prudent person" "ought to inquire" about a payment, such that the failure to inquire would amount to "a degree of negligence." In this case, inquiry notice hinged upon whether there were facts "sufficiently troublesome [so] that a reasonably prudent investor would have made reasonable inquiry, and reasonable inquiry would have revealed that the payment was made in error."

The test for inquiry notice in New York State, as defined by Judge Leval, is objective – whether or not a "prudent person" who faces the likelihood of some "avoidable loss" would "[see] fit in light of the warning signs to make [a] reasonable inquiry" into a payment's legitimacy.

Additionally, Judge Leval held that the *Banque Worms* discharge-for-value exception did not apply because the defendants were not entitled to the principal, as payment had not yet come due. The loan agreement permitted pre-payment without penalty. However, Revlon was required to first give Citibank notice of their intent to pay in full, and Citibank was required to subsequently give "prompt" notice to the lenders of Revlon's intent to pay. Revlon gave no such notice prior to the $894 Million payment.

Based upon this notice clause, and because of the "unexpected and surprising apparent repayment of the full principal amount of their loans," the Second Circuit held that defendants were indeed on "inquiry" notice that the payment was a mistake. Judge Leval held that there were at least four "red flags" which put the defendants on inquiry notice:

1. The absence of Revlon's notice of its intent to pre-pay the loan principal;
2. Revlon's financial inability to make the nearly $1 Billion payment;
3. The original loan was trading for twenty to thirty cents on the dollar, making payment of the full value imprudent; and
4. Revlon had implemented strategies to avoid acceleration of the debt just days prior to the payment.

The Second Circuit's decision in *Citibank, N.A. v. Brigade Cap. Mgmt., LP* saved Citibank from a very costly (and embarrassing) mistake. In doing so, the Second Circuit set a clear standard for what constitutes inquiry notice and constructive notice in New York.

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