



Finance / Financial Services Litigation ADVISORY ■

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Debtholders Are Not Entitled to Keep \$500 Million Mistakes

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The Second Circuit Court of Appeals [issued its decision](#) in the *Revlon* litigation, overturning the district court's finding in favor of the defendant debtholders in their dispute with Citibank over the return of approximately \$500 million of payments made by mistake. After a bench trial, the district court permitted the defendant debtholders to retain the funds that had been mistakenly transferred to them based on the "discharge-for-value" rule set forth in a New York Court of Appeals decision, *Banque Worms*. In finding that the discharge-for-value rule applied, the district court held that "on the date of the mistaken payment, the Debtholders were creditors of Revlon; each was owed – in principal and interest – the exact amount of money that they received from Citibank; neither the Debtholders nor the Defendants made misrepresentations to induce the mistaken wire transfers; nor were the Debtholders or the Defendants on notice of Citibank's mistake."

In reversing the district court's decision, the Second Circuit held that the defendant debtholders could not claim the benefit of the discharge-for-value rule because they were on notice of the mistake by Citibank: "the facts were sufficiently troublesome that a reasonably prudent investor would have made reasonable inquiry, and reasonable inquiry would have revealed that the payment was made in error." In reaching this conclusion, the Second Circuit applied the inquiry notice standard. Under this standard, "[t]he test is not whether the recipient of the mistaken payment reasonably believed that the payment was genuine and not the result of mistake. The test is whether a prudent person, who faced some likelihood of avoidable loss if the receipt of funds proved illusory, would have seen fit in light of the warning signs to make reasonable inquiry in the interest of avoiding that risk of loss."

On the facts presented, the Second Circuit found that a reasonable inquiry would have revealed the mistake. "Here, a call to Citibank would have been an easy and obvious inquiry which, unlike simply confirming internally that the size of the payment matched the size of the debt, would have answered any suspicion that the August 11 payment resulted from mistake. A payee who failed to call Citibank or Revlon, but relied instead on nothing more than ascertaining that the payment matched the debt, could not be said to have conducted a reasonable investigation."

Importantly, the Second Circuit also relied on the fact that the Revlon debt was not yet payable: "in New York, a creditor may not invoke the discharge-for-value rule unless the debt at issue is presently payable." Because "the debt on which Citibank mistakenly made a payment was not due for another three years ... Defendants may not invoke the discharge-for-value rule as a shield against Citibank's claims for restitution."

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In reaching its decision, the Second Circuit highlighted the New York Court of Appeals' "continued espousal of New York's general rule that mistaken payments should be returned." Indeed, in a concurring opinion, one circuit judge wrote that the case was straightforward: "Defendants' case fails on a more basic level: A recipient of mistakenly transferred funds cannot invoke the discharge-for-value defense... unless and until it has a present entitlement against the debtor. Put simply, you don't get to keep money sent to you by mistake unless you're entitled to it anyway."

Rather than simply issue judgment in favor of Citibank, the Second Circuit vacated the district court's order and remanded the case to the district court for further proceedings consistent with the opinion. The appeal is not yet fully resolved because the defendant debtholders can request rehearing before the Second Circuit panel that heard their appeal or before the full Second Circuit. Such requests are rarely granted. If the request is denied, the defendant debtholders can also petition the Supreme Court to hear the case; such petitions are rarely granted. We will continue to monitor the proceedings.

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