

NO. A09-2059

State of Minnesota
In Court of Appeals

American Bank of St. Paul,

Respondent,

vs.

Coating Specialties, Inc., et al.,

Defendants,

and

Co-op Credit Union of Montevideo,

Appellant,

vs.

Coating Specialties, Inc., et al.,

Defendants.

APPELLANT'S BRIEF

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STATEMENT OF THE ISSUES

I. Whether the trial court erred in granting non-subordinating bank summary judgment where the subordination agreement was ambiguous regarding specifically what subordinating bank agreed to subordinate its interest to. In particular, whether the trial court erred in implicitly determining that the parties' subordination agreement unambiguously subordinated bank's interest to all "renewals, extensions, modifications, refinances, consolidations or substitutions" of mutual borrower's underlying indebtedness with non-subordinating bank where the subordination agreement itself was silent as to specifically what subordinating bank agreed to subordinate its interest to.

Apposite Authorities:

Lamb Plumbing & Heating Co. v. Kraus-Anderson of Minneapolis, Inc., 296 N.W.2d 859, (Minn. 1980).

Donnay v. Boulware, 144 N.W.2d 711, (Minn. 1966).

II. Whether the trial court erred in failing to award subordinating bank summary judgment where an examination of the undisputed extrinsic evidence would have revealed that there existed no genuine issue of material fact that the subordinating bank agreed to subordinate its interest to two short-term notes that were subsequently satisfied.

Apposite Authorities:

Phelps v. Benson, 90 N.W.2d 533, (Minn. 1958).

III. Whether the trial court erred in granting non-subordinating bank judgment in unidentified comingled proceeds held by subordinating bank where non-subordinating

bank failed to introduce any evidence that traced said proceeds back to the converted collateral.

Apposite Authorities:

In re Oriental Rug Warehouse Club, Inc., 205 B.R. 407, 411-412 (D. Minn. 1997).
Minn. Stat. § 336.9-315 (a)(2).

I. STATEMENT OF THE CASE AND FACTS

A. PROCEDURAL HISTORY

Respondent, American Bank of St Paul (“American”), brought a cross-claim against the Appellant, Co-op Credit Union of Montevideo (“CCU”), requesting that the trial court enforce a prior subordination agreement between the parties and grant American judgment in the proceeds CCU derived from the sale and conversion of American’s collateral in the full amount of the subordination agreement. (A.8). CCU responded that the prior subordination agreement was extinguished when the underlying notes, to which CCU agreed to subordinate its interest, were paid in full. (A.116).

On February 5, 2009, the Honorable Bruce W. Christopherson, presiding, granted American summary judgment on its cross-claim, enforced the subordination agreement, and awarded American Judgment in the amount of \$50,000.00. (A.131).

On March 5, 2009, CCU filed a Motion to Reconsider requesting that the trial court vacate its February 5, 2009 Order on the following grounds: (1) there still existed an issue as to what CCU subordinated its interest; and (2) there was a genuine issue of material fact as to how much of the proceeds alleged to have been converted by CCU from the sale of American’s collateral, was attachable by American. (A.135). The trial

court granted CCU's motion and scheduled an evidentiary hearing as to the second issue only. (A.164). Said evidentiary hearing was conducted on June 18, 2009, which the trial court treated, after the fact, as a continuation of the previous summary judgment motion. (A.160). On September 15, 2009, the trial court withdrew its prior order for summary judgment and issued an Amended Order For Summary Judgment from which this appeal is taken. (A.156).

B. Facts

CCU is a credit union that, at all times relevant, held a first priority lien interest in all of Coating Specialties, Inc.'s ("CSI") assets as the result of a long-term business lending relationship between CCU and CSI. (A.17). In the spring of 2006, after CCU decided it would no longer extend credit to CSI, CSI began looking for a new primary lender and entered into discussions with American with the goal of American becoming CSI's new primary lender. (A.44).

On May 26, 2006, American loaned CSI \$25,000.00 by virtue of loan no. 50094076 with a maturity date of June 26, 2006 and secured by CCU's collateral. (A.62). On June 1, 2006, American contacted CCU with a proposed arrangement wherein American would pay off CSI's entire financial obligation to CCU. (A.49) American indicated that a private individual had agreed to offer his lake home as collateral for a new note that would be of sufficient size to buy out CCU's interest. (A.52-53). However, American believed it would take approximately 30 days to get the new loan in place. (A.122).

In the interim, American indicated that CSI was in need of operating capital. (A.122). American further indicated that it had already loaned CSI \$25,000.00 on a one-month note and was willing to loan an additional short term \$25,000.00, but would not do so unless CCU agreed to subordinate its interests relating to the full extent of the two short-term notes. (A.122).

On June 2, 2006, CCU agreed to subordinate its interest to the two \$25,000.00 short-term notes. (A.122). Also on June 2, 2006, American loaned CSI an additional \$25,000.00 by virtue of loan no. 50094164 with a maturity date of July 1, 2006 and secured by CCU's collateral. (A.1).

On June 23, 2006, without consulting or requesting a new subordination agreement from CCU, American loaned CSI an additional \$100,000.00 on a one-year note by virtue of loan no. 50094260, with a maturity date of June 22, 2007 and secured only by an assignment of life insurance in which CCU held no interest. (A.100). A portion of the proceeds of the June 23, 2006 \$100,000.00 note was applied to pay off the May 26, 2006 and June 2, 2006 short-term notes, thereby fully satisfying the underlying debt to which CCU had subordinated its interest. (A.11).

CSI subsequently defaulted on its obligations to both CCU and American. (A.11). American sued CSI and obtained a judgment on April 3, 2007. (A.11). CCU sued CSI and obtained a judgment and replevin of its collateral on September 1, 2007. (A.27). After receiving judgment, CCU replevied several pieces of CSI equipment it held as collateral. (A.22). After recovering the equipment in the Fall of 2007, CCU liquidated

the collateral and applied the \$66,790.25 in proceeds to CSI's outstanding debt to CCU. (A.22).

CCU and American each began pursuit of successor liability claims against CSI's successor company in their respective cases in the Eighth Judicial District, Chippewa County. The cases were subsequently consolidated and American made a cross-claim against CCU, seeking enforcement of the parties' subordination agreement and asking for judgment, in the amount of \$50,000.00, for CCU's alleged conversion of American's previously replevied collateral. (A.8).

II. SUMMARY OF ARGUMENT

The trial court enforced the parties' subordination agreement against a \$100,000.00 note that was not yet in existence at the time the parties entered into a subordination agreement. There was no language contained in the subordination agreement that contemplated the application of the subordination agreement to subsequent loans and the agreement failed to recite the underlying obligations to which CCU agreed to subordinate its interest. Therefore, because the subordination agreement was ambiguous, the court should have examined the extrinsic evidence to determine the intent of the parties.

Had the trial court properly determined the subordination agreement to be ambiguous, the extrinsic evidence was undisputed that CCU intended only to subordinate its interest to two \$25,000.00 short-term notes that were paid off by a subsequent note, thereby extinguishing the subordination agreement. These undisputed facts entitled CCU to judgment as a matter of law.

Finally, the trial court, after determining that CCU converted collateral in which American had a superior lien interest, awarded American judgment in the amount of the subordination agreement, \$50,000.00. This was in spite of the fact that the subordination agreement does not contain a stated amount. Also, until the proceeds in which American seeks judgment are “identified” by American, pursuant to the applicable provisions of the UCC, the court is without authority to grant such judgment. Based on these defects in the judgment, the decision of the trial court must be reversed.

III. ARGUMENT

A. THE SUBORDINATION AGREEMENT WAS AMBIGUOUS AS A MATTER OF LAW.

1. Standard of Review

A reviewing court is not bound by and need not defer to a district court's decision on a purely legal issue. *Gerber v. Eastman*, 673 N.W.2d 854, 856 (Minn. App. 2004). Construction of a contract, like the subordination agreement, is a question of law and reviewed de novo. *Turner v. Alpha Phi Sorority House*, 276 N.W.2d 63, 66 (Minn. 1979). Whether a contract is ambiguous is a legal determination in the first instance. *Blattner v. Forster*, 322 N.W.2d 319, 321 (Minn. 1982).

2. Analysis

It is generally recognized that summary judgment is not appropriate where the terms of a contract are at issue and any of its provisions are ambiguous or uncertain, in which case the trial court should allow the parties a full opportunity to present evidence of facts and circumstances and conditions surrounding its execution and the conduct of

the parties relevant thereto. *Donnay v. Boulware*, 144 N.W.2d 711, 716 (Minn. 1966). A contract is ambiguous if it is susceptible to more than one interpretation based on its language alone. *Lamb Plumbing & Heating Co. v. Kraus-Anderson of Minneapolis, Inc.*, 296 N.W.2d 859, 862 (Minn. 1980).

In our case, the parties' subordination agreement was not ambiguous as to the following terms:

Parties Co-op Credit Union and American State Bank, its successors and assigns Consideration In exchange for American's agreement to make a \$50,000.00 loan to CSI, CCU agreed to subordinate its interest to an unstated amount.

Interest being "all liens. Security interests, rights, claim subordinated and demands of every kind" in all "Inventory, accounts receivable and equipment"

However, the parties' subordination agreement was silent as to exactly what, how much, and for what duration, CCU agreed to subordinate its interest.

For instance, at first glance, it appears that the amount of subordination agreed to by CCU is \$50,000.00. However, upon closer examination, it becomes clear that the \$50,000.00 figure is nothing more than the amount American offered to loan CSI. Although the subordination agreement recites American's willingness to extend a \$50,000 loan to CSI, the agreement never states that CCU agrees to subordinate in that amount. Although such agreement may be inferred based on the extrinsic evidence, the agreement is silent and therefore ambiguous. Likewise, the agreement is conspicuously missing a termination date. It is absurd to conclude that CCU intended to extend subordination to American infinitely.

Finally, and most importantly, the agreement fails to recite exactly what it is that CCU agrees to subordinate its interest to. In any such agreement, one would expect to find a recitation of the specific notes to which the subordinating bank was agreeing to subordinate its interest. American concedes that the parties' agreement contained no reference to any specific "loan number, promissory note or any specific lending instrument". (A.24). The subordination agreement at issue in this case contains no such recitation of the underlying obligation to which CCU is subordinating its interest. Without this information, it is impossible to determine when the subordination agreement would be extinguished. Indeed, according to American's flawed interpretation, the parties' subordination agreement would never be extinguished because American could simply grant CSI another loan and apply the subordination agreement to the new loan, much like what happened in the present case. It is neither reasonable nor equitable to construe the subordination agreement such that CCU would be subjected to the whim of American's lending practices. Consequently, the silence in the subordination agreement creates the ambiguity that precludes summary judgment in this case.

American argues that CCU gave American a blanket subordination of its interest in an unlimited amount, for an unlimited duration, and to any and all loans American may choose to extend to CSI in the future, although this cannot be found in the specific language of the subordination agreement itself. (A.25). In essence, American argues that, because the subordination agreement does not expressly exclude CCU's subordination to all renewals, extensions, modifications, refinances, consolidations or substitutions of the initial two short-term \$25,000.00 notes indefinitely into the future, CCU must have

agreed to subordinate to all such renewals, extensions, modifications, refinances, consolidations or substitutions. This position is untenable.

Nowhere in the agreement did CCU agree to subordinate its interest to any renewals, extensions, modifications, refinances, consolidations or substitutions of the original two short-term \$25,000.00 notes. CCU only agreed to subordinate its interest to the two short-term \$25,000.00 notes that were in existence at the time it signed the agreement. Because the subordination agreement is ambiguous regarding exactly to what, how much, and for what duration CCU agreed to subordinate its interest, a question of fact exists and extrinsic evidence of the parties' intent should be considered. *City of Virginia v. Northland Office Properties, Ltd. Partnership*, 465 N.W.2d 424, 427 (Minn. App. 1991).

The trial court, in finding that CCU had unambiguously agreed to subordinate its interest to the subsequent \$100,000.00 long-term note, improperly added a term to the subordination agreement that called for CCU's subordination to all renewals, extensions, modifications, refinances, consolidations or substitutions of the original two short-term \$25,000.00 notes. Such language is not found within the four corners of the subordination agreement itself.

Further, the trial court's construction of the agreement is unreasonable. CCU could not (and did not) intend or agree to subordinate its interest to a long-term note that had not even been contemplated at the time the subordination agreement was signed. In addition, the financial dynamics associated with CSI's ability to service a \$100,000.00 loan are substantially and materially different than those relating to the \$50,000.00 loan

recited in the agreement. Since any potential CCU liability, arising from to the subordination agreement, would necessarily be triggered by a CSI default, it would be patently unfair to extend CCU's subordination beyond the two short-term \$25,000.00 notes, given the increased risk of default inherently associated with a larger note.

American argues that, if any ambiguity in the subordination agreement exists, such ambiguity must be construed against the drafter, CCU. *Hilligoss v. Cargill, Inc.*, 649 N.W.2d 142, 148 (Minn. 2002). While this is an accurate statement of the law, the present case is distinguishable in that, in our case, the trial court was not being asked to interpret an ambiguous term found in the language of the agreement. Rather, American was improperly asking the trial court to add an entirely new term to the parties' agreement. Such request is troubling in that a court may not interpret a contract by adding terms not otherwise found therein. *In re Marriage of Brodsky v. Brodsky*, 639 N.W.2d 386 (Minn. App. 2002).

3. Conclusion

Because, the plain language of the subordination agreement itself is silent as to exactly what, how much, and for what duration CCU agreed to subordinate its interest, the agreement is ambiguous. Also, the agreement does not contain language to support the trial court's conclusion. Therefore, the trial court erred in not allowing the admission of extrinsic evidence to determine the parties' intent.

B. THE UNDISPUTED EXTRINSIC EVIDENCE SUPPORTS REVERSAL AND REMAND.

1. Standard of Review

On appeal from summary judgment, it is the function of the appellate court to determine whether genuine issues of material fact exist and whether the trial court erred in its application of the law. *Betlach v. Wayzata Condominium*, 281 N.W.2d 328 (Minn. 1979).

2. Analysis

Although CCU did not make a formal cross-motion for summary judgment, CCU was entitled to such pursuant to Rule 56 of the Minnesota Rules of Civil Procedure, which provides for summary judgment in favor of the non-moving party. Minn. R. Civ. P. 56. Had the trial court properly determined that the subordination agreement was ambiguous, the following undisputed facts support an award of summary judgment in CCU's favor. Therefore, the judgment should be reversed and remanded for consideration of the extrinsic evidence.

a. **The \$50,000.00 loan referenced in the subordination agreement contemplated the May 2006 and the June 2, 2006 notes.**

Pleadings are part of the record in the case and either party has the full benefit of any statement or admission contained in the pleading of the opposite party without putting such pleading in evidence. *Stephenson v. Stephenson*, 104 N.W.2d 517, 519 (Minn. 1960). When essential facts are admitted by the pleadings, they no longer are in issue. *Phelps v. Benson*, 90 N.W.2d 533, 546 (Minn. 1958).

In our case, CCU's subordination to the loans dated May 26, 2006 and June 2, 2006 were alleged, not only in the Affidavit of Lee Sorenson, (A.122), on behalf of CCU, and in the deposition of Diane Zuidema (A.48), on behalf of American, but, more

importantly, in American's Amended Cross-Claim. (A.3). Therefore, the fact that the subordination agreement only contemplated the loans dated May 2006 and June 2006 was established as a matter of law.

- b. **There is no language contained in the subordination agreement that indicates CCU's intention to subordinate its interest to any renewals, extensions, modifications, refinances, consolidations or substitutions of the original two short-term \$25,000.00 notes.**

Although American tacitly argued in its summary judgment motion that, because the Business Loan Agreement signed by American and CSI included language defining "Note" to mean all "renewals, extensions, modifications, refinances, consolidations or substitutions", CCU had agreed to subordinate its interest to the alleged \$100,000.00 consolidation loan. (A.24). However, CCU was not a party to said Business Loan Agreement and therefore was not bound by its terms. Likewise, American's explicit argument that collateral security that has been pledged for payment of a debt is not released by acceptance of a new note is equally misplaced in that a subordination agreement is not collateral for a note. (A.128). Collateral is property pledged as security for a debt. Black's Law Dictionary 179 (abridged 6th ed. 1991). A subordination agreement, on the other hand, is a contract relating only to the ranked priority of a secured party's interest in collateral. *Id.* at 994. CCU asserts that it was these arguments that misled and confused the trial court.

- c. **The two short-term \$25,000.00 notes were paid off and fully satisfied with the proceeds from the subsequent \$100,000.00 note.**

The Disbursement Request and Authorization provided by American speaks for itself in unequivocally indicating how the proceeds of the \$100,000.00 note were

disbursed. (A.111). Because the obligations to which CCU agreed to subordinate its interest were satisfied in June of 2006, the subordination agreement was extinguished at that time.

- d. There is no language contained in the subordination agreement that indicates CCU's intention to subordinate its interest to a \$100,000.00 note, nor did CCU enter into any further subordination agreement with American.**

The subordination agreement recites American's willingness make a \$50,000.00 loan to CSI in exchange for subordination from CCU. (A.112). The subordination agreement itself is silent as to the extent CCU was willing to subordinate its interest to the recited \$50,000.00 loan, much less an un-recited \$100,000.00 note. *Id.*

- e. American sued CSI for defaulting on the \$100,000.00 note alone and received judgment against CSI in the amount of \$76,851.92 on April 3, 2007.**

American sued CSI only on the \$100,000.00 note. (A.168). American did not receive judgment on either of the two \$25,000.00 short-term notes contemplated in the subordination agreement because they had already been paid off. (A.111). Also, the \$100,000.00 note was secured only by an assignment of life insurance and not any collateral in which CCU held an interest in the first instance. (A101).

3. Conclusion

Because there exists no genuine issue of material fact that the two \$25,000.00 short-term notes, in which CCU subordinated its interest, were satisfied, thereby extinguishing the subordination agreement in June of 2006, the Court should remand this

case back to the trial court with instructions to consider the extrinsic evidence in deciding any and all summary judgment motions.

C. THE TRIAL COURT ERRED IN GRANTING AMERICAN JUDGMENT IN UNIDENTIFIED COMINGLED PROCEEDS HELD BY CCU WHERE AMERICAN FAILED TO PRODUCE ANY EVIDENCE THAT TRACED SAID PROCEEDS BACK TO THE CONVERTED COLLATERAL

1. Standard of Review

Interpretation of a statute is a legal question, which this court reviews de novo. *Brookfield Trade Center Inc. v. County of Ramsey*, 584 N.W.2d 390, 393 (Minn. 1998).

2. Analysis

In the Court's Order, American was granted judgment against CCU in the amount of \$50,000.00 in the proceeds alleged by American to have been derived from of a sale of American's alleged converted collateral.

As an initial matter, CCU argues that the \$50,000.00 was arbitrary in that the subordination agreement itself did not provide a specific amount in which CCU agreed to subordinate its interest. (A.112).

More fundamentally, the trial court erred because, under Minnesota's version of the Uniform Commercial Code, only proceeds that are "identifiable" are attachable by a secured creditor in a conversion action. Minn. Stat. § 336.9-315(a)(2). American has neither produced any evidence, nor alleged that CCU was holding any such identifiable proceeds, despite having the burden to do so. See Minn. Stat. § 336.9-315; See also *In re Oriental Rug Warehouse Club, Inc.*, 205 B.R. 407, 411-412 (D. Minn. 1997).

In other words, once collateral is converted to proceeds, and those proceeds are comingled with other funds, the secured party has a duty under the law to prove that the specific funds, in which he requests judgment, originated from the sale of the converted collateral. *In re Oriental Rug Warehouse Club, Inc.*, 205 B.R. at 411-412. Once the proceeds are properly traced back to the original collateral, they are considered identifiable. Tracing is critical in that a court is without jurisdiction to award judgment in unidentified proceeds. *Id.*

In our case, there was absolutely no evidence in the record that American conducted any tracing or that the proceeds in which American was granted judgment were identifiable. As a result, there remains a genuine issue of material fact relating to whether CCU is holding any identifiable proceeds to which American's alleged interest could attach.

3. Conclusion

The court of appeals should reverse the judgment because the UCC requires that only identifiable proceeds are attachable and the record contains no evidence that CCU was holding identifiable proceeds. The district court failed to confront this issue although it was raised on reconsideration. Therefore, this case should be remanded for further proceedings to allow the court to hear evidence regarding the identification of the proceeds in which judgment was granted.

IV. CONCLUSION

For the reasons provided above, CCU respectfully requests that the Court reverse the decision of the trial court and remand with instructions consistent with its opinion.

Dated: December 10, 2009

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