

67939-2

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No. 67939-2-1

**COURT OF APPEALS – DIVISION ONE
IN AND FOR THE STATE OF WASHINGTON**

SCOTT BANCHERO, an individual,

Appellant

v.

MICHAEL YERKOVICH, in a derivative
capacity and individually,

Respondent.

APPELLANT'S REPLY BRIEF

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APPELLANT'S REPLY BRIEF

Yerkovich willingly surrendered control of the corporation to Banchemo when he conveyed 1% of his shares to Banchemo in recognition of Banchemo's efforts in growing the corporation's business while Yerkovich was in police custody in Mexico. This is why the First Amendment to the Shareholders' Agreement was entered into by the parties in March of 2006. [Exhibit 7] Upon becoming majority shareholder, Banchemo possessed the power to determine the board of directors. For Yerkovich to now contend that he never intended to surrender control of the corporation to Banchemo is patently disingenuous.

I. ARGUMENT

A. **The court improperly awarded judgment in favor of Yerkovich in his capacity as an individual shareholder, rather than to Pinnacle in its derivative capacity.**

1. **Yerkovich's contention that this issue is raised for the "first time" on appeal.**

Yerkovich contends that the error committed by the trial court in awarding judgment to him personally rather than to Pinnacle cannot be raised for the "first time" on appeal, and thus this assignment of error may not be considered by this Court, citing *Fisch v. Marler*, 1 Wash.2d 698, 97

P.2d 147 (1930; Gill v. Strouf, 5 Wash.2d 426, 105 P.2d 829 (Wash. 1940). Neither case has any application.

In *Fisch*, the court held that a question not raised in any manner before the trial court would not be considered on appeal, adding that an additional reason for not considering the matter was that the respondent did not appeal from the order, concluding that the issue of attorney fees sought to be raised was resolved by the trial court and *res judicata*.

In *Gill*, the failure to plead usury as an affirmative defense precluded its consideration on appeal.

Neither does *Lawson v. Helmich, 20 Wash.2d 167, 146 P.2d 537 (1944)* have any application. In that case, the entire theory of the respondent's claim, while not presented in the trial court, was nonetheless considered by the appellate court.

Likewise, *State ex rel York v. Board of Commissioners of Walla Walla County, 28 Wash.2d 891, 184 P.2d 577 (1947)* has no application because the appellant sought to raise, for the first time on appeal, constitutional issues involving denial of equal protection under the Fourteenth Amendment when no constitutional question was submitted to the trial court.¹

¹ This case is also of questionable authority because RAP 2.5(a) specifically empowers an appellate court to address a constitutional issue for the first time on appeal.

Yerkovich also relies upon *State v. Long*, 58 Wash.2d 830, 365 P.2d 31, (Cert. denied 374 U.S. 850, 852, 10 L.Ed.2d 1070, 1073, 83 Sup. Ct. 914, 919). In *Long*, the court found that the issues addressed on appeal were frivolous and were not brought to the attention of the trial court, but nonetheless the court proceeded to consider them anyway.²

Yerkovich then cites 13 additional cases on page 17 of the respondent's brief without any discussion. Banchero is not obligated to distinguish authority cited without discussion which should not merit the attention of this Court. The remaining two cases briefly referenced on page 17 of the respondent's brief, i.e., *Miller v. Staton*, 58 Wash.2d 879, 365 P.2d 333 and *Titus v. Tacoma Smeltermen's Union Local No. 25*, 62 Wash.2d 461, 383 P.2d 504 (1963), dealt with the failure of an appellant to take exception to a jury instruction which precluded appellate review.

Yerkovich contends that Banchero has failed to " . . . cite any portion of the record to support that he raised the question of whether or not Yerkovich could be awarded a judgment in his individual capacity in the trial court." [Resp. Brief, p. 17] This is incorrect. Banchero testified on cross-examination by his counsel that he committed an error of

² *Long* was reversed by *Draper v. State of Washington*, 372 U.S. 487, 83 Sup.Ct. 774, 9 L.Ed.2d 889 (U.S.Wash. March 18, 1963), holding that the finding of a trial court in a particular issue on appeal to be frivolous would not be sustained when the effect is to deprive an indigent defendant of an adequate record to enable appellate review.

judgment in making this excessive distribution to himself and that he was prepared to return the money to the corporation. He stated:

Q. Mr. Banchemo, on direct examination, Mr. Lyons asked you about \$104,000 which you apparently paid from the corporation for your income taxes for 2008. Do you recall that?

A. Yes.

Q. Did you do that?

A. Yes.

Q. Why did you do that?

A. It came out of withholding and had to come from the company, so I paid it out of the company.

Q. Why did it have to come from the company?

A. That's where withholding would come from.

Q. Well, did you consult with Mr. Christophel concerning whether or not his –your tax liability for 2008 should be paid out of the company?

A. Yes. It needed to come out of the company's checking account.

[Trans. 2/7/2011, p. 8:6-21]

* * * *

Q. Well, what is your intention with respect to that issue at this time?

A. To make the adjustment.

Q. Adjustment in what amount?

A. 104,000.

Q. Return it to the corporation?

A. Correct.

[Trans. 2/7/2011, p. 9:8-14]

In *Lunsford v. Saberhagen Holdings, Inc.*, 160 P.3d 1089 (Wash.App. Div. I 2007), the court held that generally failure to raise an issue before the trial court precludes a party from raising it on appeal, but if an issue raised for the first time on appeal is arguably related to the issues raised at the trial court, the court may exercise its discretion to consider newly articulated theories for the first time on appeal. The Court of Appeals has inherent authority to consider all issues necessary to reach a proper decision. *Heiderkan v. State Department of Natural Resources*, 993 P.2d 934 (Wash. App. Div. II 2000). While the general rule is that a party may not raise an issue for the first time on appeal that it did not raise below, such rule is *permissive*, and does not automatically preclude the introduction of an issue at the appellate level. *In re Welfare of BRSH*, 141 Wash.App. 39, 169 P.3d 40, Wash.App. Div. II, 2007.

2. It was error for the trial court to award judgment in favor of Yerkovich, rather than to the corporation.

Pinnacle Processing Group, Inc. (“Pinnacle”) is a sub-Chapter S corporation. Distributions to shareholders must “pass through” the corporation for distribution to the shareholders to be reported as ordinary income on their individual tax returns. [RP, 2/3/2011, pp. 196-197] This is accomplished with the preparation of a “K-1” form which each sub-Chapter S shareholder must include with his Form 1040 individual tax return for a given calendar year. By its very nature, a sub-Chapter S corporation operates free from corporate taxation, and thus enables the shareholders to avoid “double” taxation, e.g., taxation on corporate dividends followed by taxation on those dividends as ordinary income to the shareholder recipient.

Yerkovich apparently recognized this fact when he brought this action in a derivative capacity seeking recovery for the benefit of the corporation. Yerkovich’s claim is for excessive *distributions* which remained from the corporation’s gross revenues to Banchemo, its majority shareholder. Restoration of this excessive distribution to the corporation must necessarily follow; once this money is returned to the corporation it may then be distributed to Yerkovich consistent with IRS regulations governing reporting of income by shareholders of a sub-Chapter S

corporation.

The court thus committed reversible error in disregarding not only the fact that this is a stockholder's derivative action, but that the shareholders are conducting their business according to a sub-Chapter S election.

B. The court erroneously awarded judgment to Yerkovich without taking into account his termination on August 8, 2008, depriving Banchemo of the value of the services he performed for the corporation after Yerkovich left his employment.

1. Banchemo's position as director and chief executive officer of the corporation empowered him to fix the salaries of officers.

Yerkovich has failed to address the clear error committed by the trial court in erroneously awarding judgment to him without taking into account his termination on August 8, 2008, depriving Banchemo of the value of the services he performed for the corporation after Yerkovich left his employment.

Yerkovich devotes scant attention to this assignment of error, which is supported in detail beginning on page 18 of Banchemo's opening brief, followed by analysis including citations to the record set forth in considerable detail on the 17 pages which follow. First, Yerkovich

erroneously argues that the court correctly found in Finding No. 6 that Banchemo acted as the corporation's "only director" and that
"*. . . Banchemo lacked the authority to replace Yerkovich as the sole director since he failed to give notice to Yerkovich as a shareholder in violation of the law and PPG bylaws and further because Banchemo's claim as a majority shareholder was invalid.*" [CP, 142, FF #6, quoted verbatim, p. 18, App. Opening brief] This was refuted by the annual corporate license renewal filed by Pinnacle for 2005, 2006 and 2007 in which Yerkovich was reported as the resident agent and president, and Banchemo as the secretary and sole director, and signed by Banchemo as chairman of the board. [Ex. 9]

Yerkovich fails to address in his responding brief the clear error of the court in disregarding the bylaws of the corporation, amended at the annual meeting of the shareholders held January 3, 2008 by which section 3.1 was amended to add the position of CEO. [Ex. 9, excerpted as Appendix A, App. Open. Brief] At that meeting, it was also resolved to amend the corporation's license renewal and annual report form to the Secretary of State designating Yerkovich as president, Sandra Farah as secretary, and Banchemo as treasurer and chairman of the board.

According to section 4.1 of Pinnacle's bylaws, "*. . . [T]he salaries of the officers of the corporation shall be fixed from time to time by the board of*

directors.” [Ex. 2, p. 4] See Appendix A, appellant’s opening brief, page 2, containing the minutes of the corporate meeting of Pinnacle Processing Group, Inc. dated January 14, 2008 reciting the attendance of Michael Yerkovich. The minutes reflect that Yerkovich even nominated a friend to the board of directors.

The court improperly found in conclusion number 10, Yerkovich to be Pinnacle’s sole board member, when in fact Banchemo utilized his power as majority shareholder at a properly noticed annual meeting of the shareholders attended by Yerkovich on January 3, 2008 to amend the bylaws and allocate to himself the powers of sole director and with it the power to set the salaries of the officers of the corporation. It was therefore clear error for the trial court to conclude as a matter of law that the First Amendment did not permit Banchemo to unilaterally set salaries or to set salaries more favorable to him than to Yerkovich. [CP, 140]

2. **By their conduct in running the corporation in working together during 2006, 2007 and until August 8, 2008, the parties displayed a clear intention to work full-time for the success of the business.**

Yerkovich has also failed to address the failure of the record to contain any convincing evidence that either shareholder intended that the other work for the corporation without compensation. In the face of this conflicting evidence, the court committed reversible error by failing to

take into account the conduct of the parties during the previous three years, their respective reporting of salaries on their federal income tax returns for 2006 through 2008, and Yerkovich's admission that he knew as a result of advice from the corporation's tax preparer, Robert Christopfel, that a reasonable amount of sub-Chapter S income would have to be reported as salary. [RP, 2-2-2011, p. 51] Nor has Yerkovich addressed the erroneous finding by the trial court that Banchemo's salary was hidden from him after he was removed as president in August of 2008 notwithstanding that he signed his tax returns in 2006, 2007 and 2008 reporting salaries for each of those years.⁴ Nor has Yerkovich offered any explanation why the court could properly absolve him of any responsibility as president of the corporation to look not only at his own individual tax returns for these years, but also to examine the corporation's tax returns, and compare them to the shareholder loan accounts before signing his individual tax return. Other than to argue that the court was presumably correct in its assessment of damages, Yerkovich has failed to explain how he is not being rewarded for his feigned ignorance of the

⁴ Finding No. 13 states that: ". . . Yerkovich discovered that Banchemo had unilaterally acted to increase his own compensation in a manner inconsistent with the 2006 contract. Yerkovich ascertained that Banchemo had increased his own salary from \$79,800 in 2006 to \$300,000 in 2007 and again to \$450,000 in 2008. These financial maneuvers were hidden from Yerkovich and not discoverable due to his removal as president and removal from access to PPG's bank accounts." [CP, p. 134]

financial reporting which was undertaken by Robert Christopfel at a time when Yerkovich was president of the corporation.

3. Yerkovich ignores the role of Robert Christopfel, CPA, in guiding Banchemo in reporting the income of the corporation

Yerkovich has failed to address the role of Robert Christopfel in his management of the financial affairs of the corporation as reflected in the preparation of the individual income tax returns for 2006 through 2008, together with his preparation of the corporate tax returns, Form 1120S, and the form K-1 returns for each of the shareholders which they submitted to the Internal Revenue Service with their individual tax returns for those years. [Ex. 23, 24, 29, 30, 48, 49, 50, 51, 91, 92] There is no effort made by Yerkovich in his responding brief to refute Christopfel's testimony that in an S-corp setting salaries to shareholders must have some reasonable relationship to the services provided. See discussion, pages 26 – 27, appellant's opening brief. Nor has Yerkovich offered any explanation concerning his acquiescence during these years in the reporting of salaries and the necessity for doing so as outlined in Christopfel's testimony. See discussion, quoting from testimony of Christopfel, on page 28 of the opening brief.

The court was not free to disregard Christopfel's testimony, and Yerkovich does not argue that it should have done so. Nor was the court

free to disregard the fact that the parties were doing business as a sub-Chapter S corporation which carries with it the responsibility to act in compliance with Internal Revenue Service guidelines.

Finally, Yerkovich completely fails to address the significance of the e-mail exchange which occurred on April 2, 2009 between Larry Davidson, general counsel for Pinnacle, and Christopfel concerning requests from Yerkovich's counsel for financial information. Yerkovich was sufficiently concerned with his tax liability for 2008 to have retained counsel for the purpose of examination of the corporation's financial records *before* signing his 2008 individual tax return reporting a salary in the amount of \$275,000 for that year, when in fact it represented \$147,553.69, carried forward from 2006 and 2007, consisting of officer loans on which he had not reported and had paid no income tax. [Ex. 9, 26] The failure of the trial court to take these facts into account before ruling that neither shareholder was entitled to salaries which they reported to the Internal Revenue Service was clear error.

4. **In Washington, the subjective intent of the parties is entitled to no weight in the interpretation or construction of a contract.**

Yerkovich has made no effort to address Banchero's argument in his opening brief that the subjective intent of the parties to a contract is entitled to no weight, instead requiring the court to determine the intent of

the parties or to resolve an ambiguity apparent from the contract by resort to extrinsic evidence. See discussion on page 32 of appellant's opening brief. Yerkovich must be presumed to have conceded this to be a correct statement of the law and that the failure of the court to construe the contract according to extrinsic evidence of the parties' conduct is manifest error.

5. The court erroneously awarded Yerkovich \$160,783.80 for his share of net profits for 2008 without regard to his termination of employment with Pinnacle on August 8, 2008.

Yerkovich has failed to explain why the court was correct in disregarding the value of the services performed by Banchemo during 2008 in Yerkovich's absence in awarding damages against Banchemo in the amount of \$246,986. See discussion on pages 33 and 34 of appellant's opening brief. Yerkovich has failed to explain in his responding brief why the value placed by the court on Banchemo's services during 2008 should be disregarded.

If, on the one hand, it is reasonable to assume that when the parties signed the First Amendment that both intended to work full-time for the benefit of the business, it is patently unreasonable to conclude that both parties would expect to be paid equally from the net profits of the corporation without regard as to whether each party worked for the

corporation during a particular calendar year, and the extent of the service provided.

Yerkovich has failed to address in his responding brief the unfairness of the failure of the trial court to take into account the \$128,432.40 which he received in 2008 in order to fix the value of Yerkovich's services for that calendar year, together with those of Banchemo. If the court committed reversible error in its interpretation of the contract when it concluded that the shareholders were not entitled to receive salaries, then it must be presumed that Yerkovich is in agreement with the calculations set forth on page 34 of the opening brief in which it is argued that Yerkovich is entitled to \$27,511.65 for 2007, plus prejudgment interest at 12% from 12/31/2007, and \$45,889.69 for 2008, plus prejudgment interest at 12% from 12/31/2008. Pinnacle would thus be entitled to judgment in the amount of \$101,339.91 as Yerkovich has offered no challenge to this methodology in calculating the amount of distributions to which he would have been entitled.

II. CONCLUSION AND RELIEF SOUGHT

Upon the record of this case, as a matter of law, the judgment should be vacated and judgment entered in favor of Pinnacle and against Banchemo in the amount of \$101,339.91 for distribution to Yerkovich

consistent with his status as a 49% shareholder of a sub-Chapter S corporation.

DATED this 14th day of June 2012.

Respectfully submitted,


Eric Zubel, WSBA, #33961
ERIC ZUBEL, PC
Attorney for Appellant

CERTIFICATE OF SERVICE

I, Cathy Hodges, am over the age of 18 years and certify under penalty of perjury under the laws of the State of Washington that I caused to be served on the persons listed below, in the manner shown, the following documents:

APPELLANT'S REPLY BRIEF

I caused to be served the above identified documents, on this day, June 14, 2012, via Legal Messenger, to the following:

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I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 14th day of June, 2012.

ERIC ZUBEL, PC

Cathy Hodges
Cathy Hodges
Legal Assistant