

# **Are You Personally Liable for Your Business's Debts?**

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**Learn whether a business creditor can come after your house, bank account, or other personal property.**

If your business is having trouble paying its bills, you may be worried about whether a creditor can come after your personal assets. Can a creditor raid your personal bank account? Garnish your wages? Foreclose on your house?

To answer these questions you need to understand whether you are personally liable for your business's debts. If you aren't personally liable for your business's debts, you have a lot less to worry about: a creditor can only go after your business's bank account and assets if your business doesn't pay its bills; creditors can't take your home or other personal property. But if you find out you are personally liable for your business's debts, you have a lot more to lose.

Which debts are you personally liable for? First, know that every business owner who has employees, no matter whether the business is organized as a corporation, LLC, partnership, or sole proprietorship, is personally liable if the business doesn't pay the taxes it withheld from employees' paychecks. Second, for other types of business debts, your business structure as well as what kind of contract or purchase order you signed usually determines whether or not you're personally liable for a business debt. Let's take a look.

## **Sole Proprietorships and Partnerships**

If you're operating your business as a sole proprietorship (or "DBA" or as an independent contractor), you and your business are legally the same, which is another way of saying that you personally owe every penny that your business can't pay. So if your business doesn't have enough cash or assets to pay its debts, creditors can, and sometimes will, take your personal assets – or at least the assets that aren't protected by state exemption laws.

This is also generally true for general partnerships -- the partnership debt belongs to each partner personally -- with this added twist: Each partner is personally liable for 100% of the business's debts. This means that if there aren't enough business assets to pay the partnership's debts, and your partners are broke, creditors can take your partner's personal assets to pay *all* of the business's debts, not just your pro rata share of the debts.

## **Corporations and LLCs**

If your business is organized as a corporation or LLC, you and your business are separate legal entities. As such, in theory you could have no personal liability for the debts of your

business, meaning that creditors can't take your house or other personal assets to pay your business's debts, even if your business can't pay them.

However, there are many ways for a shareholder or LLC member to become personally liable for business debts; in fact, most owners of small businesses are personally liable for at least some business debts. Here are the most common ways the owner of a corporation or LLC can become personally liable.

### **Signing a Personal Guarantee**

Because most suppliers, banks, and landlords know that shareholders or LLC members don't have personal liability for the corporation or LLC's debts, they often won't extend credit or loan money to a small LLC or corporation without the owner's personal guarantee. If you signed a personal guarantee for a particular loan, lease, or contract, you promised that you would pay it personally if your business did not. Put another way, every time you personally guaranteed that you would repay a debt, you deliberately gave up your limited liability for that debt. You volunteered to let the creditor sue you to take your personal assets if the business couldn't pay the debt.

Check to see if you signed a personal guarantee on all of your business contracts; for example, a loan for a business vehicle or business equipment, trade terms with a supplier, a bank line of credit, or a commercial lease.

### **Offering Your Property as Collateral**

Banks typically require the owners of small corporations or LLCs to put up their house or other real estate as security for a loan. If you secured a business loan or debt by pledging property such as a house, boat, or car, you are personally liable for the debt, and if your business defaults on the loan, the lender or creditor can sue you to foreclose on the property and use the proceeds to repay the debt.

### **Signing a Contract in Your Own Name**

You may also have given up your limited liability if you were careless about signing purchase agreements and service contracts. Sometimes these agreements display the personal name of the business owner without the name of the corporation or LLC. If you signed an agreement in your personal name and not on behalf of the corporation or LLC, you're personally liable for the underlying debt, even if it was the supplier's mistake. If you're not sure whether you have given a personal guarantee on an agreement or loan, check both the language of the agreement and the signature block to see whether you signed it in your name or in your capacity as an owner or officer.

**Example:** Talia signs a loan contract as Talia Smith, CEO of Book Nook, Inc., so only her business is liable to repay the loan. But she signs her commercial lease as just Talia Smith, so she will be personally liable to the landlord if her business can't pay the rent.

## **Using Credit Cards or Personal Loans to Fund the Business**

You may have used credit cards or home equity loans to obtain funds for your business, which definitely means you are personally liable for those debts. (You are almost always personally responsible for making payments on your credit cards, even if they have your business name on them, under the terms of the application you signed.)

## **Fraud, Misrepresentations, or Sloppy Recordkeeping**

If you personally misrepresented or lied about any facts when you were applying for a loan or credit on behalf of your corporation or LLC, you could be held personally liable for the debt. Likewise, if you failed to maintain a formal legal separation between your business and your personal financial affairs, creditors could try to hold you personally responsible for the business's debts under a theory known as "piercing the corporate veil." This happens when a court finds that your corporation or LLC is really just a sham and that it is you personally operating the business. One way creditors try to pierce the corporate veil is by showing that you didn't observe the formalities imposed on corporations and LLCs by state law. For instance, you may have made important corporate or LLC decisions without recording them in minutes of a meeting. Or you may have paid a number of the business's bills out of your personal checkbook or with a personal credit card. Even corporations or LLCs owned by a single individual or a married couple have to obey these rules and formalities.

## **Next Steps**

If you've determined you're personally liable for all or some of your business's debts, you risk being sued personally for the debt. If you think it's likely you'll be sued, you'll want to make sure that your business pays the debts off, either in full or by negotiating a settlement for less than you owe. If that's not possible, you may be able to file for Chapter 7 personal bankruptcy to wipe out your personal liability for your business debts. For more information on your options, see *Save Your Small Business: 10 Crucial Strategies to Survive Hard Times or Close Down and Move On*, by Ralph Warner and Bethany K. Laurence (Nolo), due out in August 2009.

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