

When You Can't Pay Your Business Debts: Personal Liability and Bankruptcy Options

by Attorney Shannon Mieke

If your business is in the red, take steps to protect your personal assets.

If your business is in distress -- you owe a lot of money but you can't pay -- your creditors will probably threaten legal action against you personally. How much they can collect will depend on how your business is organized, whether you personally guaranteed any repayments, and whether you decide to file for bankruptcy.

Payroll Taxes: You're Personally On the Hook

The IRS holds all business owners personally liable for unpaid payroll taxes, regardless of your business's structure.

Sole Proprietors and Partnerships

If you're a sole proprietor, you and your business are legally one and the same, so you're personally responsible for all debts. If there isn't enough money in the business to pay these debts, creditors can and will take your personal assets.

In a general partnership, each partner is personally liable for the entirety of the business's debts (and any partner can usually bind the entire partnership to a business deal -- a scary combination). This means that if there isn't enough money in the business to pay the debts, and your partners are broke, creditors can take your personal assets to pay *all* of the business's debts, not just your share.

Corporations and Limited Liability Companies

If your business is organized as a corporation or a limited liability company (LLC), your personal assets are usually protected from business creditors -- unless you specifically gave up your so-called "limited liability" protection.

Unfortunately, you may have done so if a bank or other creditor required a personal guarantee and/or personal security before loaning you money, leasing you space, or extending credit. It's a common practice. Such personal guarantees undo your limited liability, allowing the creditor access to your personal assets if the business can't cover the debt. A creditor can also ask a business owner to secure a business debt by pledging specific personal property, such as a house, boat, or car.

The Bankruptcy Option

If your business bank account is empty and you're in a lot of debt, you might be considering bankruptcy. Although it won't guarantee you'll get to keep your house or other property, it can at least give you some breathing room. And you'll be able to keep the basic necessities of life (clothing, furniture, and so on), as well as some or all of your equity in your house and car.

Business vs. Personal Bankruptcy

If you're a sole proprietor, you can file for either Chapter 13 or Chapter 7 bankruptcy. Either can be used for personal debts or business debts.

If you're a corporate shareholder, LLC owner, or partner in a partnership and you've signed personal guarantees or pledged collateral for business loans, putting your *business* through bankruptcy won't protect your personal property.

So let's assume you want to file for personal bankruptcy, either using Chapter 7 or Chapter 13. In a Chapter 7 bankruptcy, your assets (except for property that's exempt under state or federal law) can be sold to pay off your creditors. At the end, all your debts that are eligible for discharge in bankruptcy will be wiped out.

In a Chapter 13 bankruptcy, you propose a repayment plan where you repay part or all of the debt over three to five years. You don't lose any property in a Chapter 13 bankruptcy; instead, you pay off your debts using your income.

How Bankruptcy Might Help

When you file for bankruptcy, something called an automatic stay immediately stops your creditors from foreclosing on your house or any other personal property. This can buy you time, if nothing else.

Beyond this, the type of debt you have will affect how and whether bankruptcy can help you. Bankruptcy wipes out most unsecured debts (for example, credit card bills and lawsuit judgments), but secured debts are a bit different. If you pledged property -- such as your home -- as collateral for a loan, the creditor is entitled to take the property, even if you file for bankruptcy. Although you may not have to pay back what you owe on the loan, even if it's more than your home is worth, you will lose your home. You may have the right to keep some of your equity in the home, however.

Filing for Chapter 13 might be a better option if you're faced with losing property you really want to keep. In Chapter 13, you can include the debt in your repayment plan, spreading the payments out over five years. This gives you a better chance of making good on the debt, which will allow you to keep your property.

If you're in imminent danger of losing your family's home or livelihood, get in touch with a knowledgeable small business attorney with bankruptcy experience.

Further Information

Learn what steps you should take -- or avoid -- to stay out of trouble with the IRS and the courts, in [Ten Tips for Financially Troubled Businesses](#).

If you're considering selling most or all of your business assets, see [Eight Key Steps to Selling Your Business](#).

When everything else has failed, see [Closing Your Business: What You Need to Do](#).

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