

Personal Liability and the



Corporate Shield

Dropping Your Guard

By Paul Kellogg

Many business owners have been advised that they should operate their businesses as corporations, partnerships, limited liability companies, or trusts to protect themselves and their personal assets from any liability associated with the business. Although an entity formed under Texas law is separate from its owners, thereby providing a “shield” against personal liability for debts and liabilities (judgments) incurred by the business, that shield can be penetrated for a variety of reasons. In other situations, the shield doesn’t apply. If business owners aren’t careful, some very serious problems can land at their feet. These include personal liability for federal and state taxes, guaranties, and indemnifications.

Personal Acts

One obvious category of personal liability is wrongful acts committed by the business owner herself. Even if the owner is acting in her official capacity, the corporate shield will not protect her from her own misdeeds. The shield does not protect against charges of

discrimination, sexual harassment, assault, bank fraud, or a host of other acts. Nor does it protect against non-payment of certain kinds of taxes, as explained below. For example, imagine a business owner who is angry that the business next door is so noisy that it is driving away his customers. Is he acting on behalf of his business, or in its name, if he assaults the owner of the business next door? Maybe, but he is most certainly also guilty of assault and battery.

Sign Here

Another familiar source of personal liability is the personal guaranty. Lenders and vendors frequently make a guaranty a condition of granting a loan or line of credit, opening an account for utilities, purchasing equipment in installments, or leasing real property. The guaranty is a lengthy and legally dense document that, in essence, says you are personally responsible for all debts incurred by the business, and that the lender or vendor does not have to sue the business or seize its assets before attempting to collect from you personally. It also

eliminates or waives many defenses you might otherwise have. It is nearly impossible to avoid a guaranty unless there are enough tangible assets with strong resale value to cover the debt—which is not the case for most small businesses. In Texas, many personal assets are exempt from seizure for personal debts (more on that below), but a guaranty can still be an effective pressure point. The guaranty usually extends for several years. Many businesses don’t survive for that long, which increases the chances that the business owner’s assets will be at risk. The best strategy is to obtain a time limit on the guaranty, or use a formula that allows it to decrease over time as the business proves that it is stable and will be around to pay its debts.

Nothing Personal

Some business owners feel that whatever wealth they have created in their business is theirs to spend as they wish, even if other investors or minor owners are involved. This view poses two problems. First, the majority owner, who typically runs the operation and controls the bank account,

is obligated to treat his investors and other owners fairly. Taking more than his share, or using business funds for personal expenses, can violate that duty, for which the majority owner is personally liable.

Second, an owner who diverts business funds for personal purposes is removing assets that would otherwise be available to creditors. If that is true, the court may “pierce the corporate veil” and allow the creditor to go directly to the owner’s personal assets for compensation.

If the owner commingles business funds and personal funds and uses those funds interchangeably, a court could hold that the business is nothing more than an “alter ego” of the owner, and therefore hold the owner personally responsible for any judgment against the business. An owner can also fall into this trap by ignoring corporate formalities, such as failing to maintain the business’s charter or failing to file separate tax returns for the business.

Finally, an owner can create personal responsibility by failing to use a title when signing checks or contracts. If an individual signs just his name, it is presumed that he is acting as an individual. Conversely, if she signs as “Jane Smith, Pres.” on a business check, or “Jane Smith, President of XYZ, Inc.” on a contract, she is presumed to be acting as an officer of that business, and therefore is not personally liable for the obligation. Titles matter.

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Un-Chartered Waters

Most businesses in Texas are required to file a state tax return every year, along with a Public Information Report (PIR) listing the officers and directors and any affiliated companies. The PIR is a simple document, but business owners and accountants often overlook it. If it is not filed, the business is not in compliance and is subject to losing its charter. The State Comptroller will notify the business by letter to its registered office. If the letter is returned (if, for example, the business has moved) or not answered, the Comptroller will notify the Texas Secretary of State (SOS) to cancel the business’s charter. If that happens, the members of the governing body of the company (i.e., directors, managers, general partners) will be personally liable for any acts performed by the

business during the period when the company did not officially exist (i.e., the period between the cancellation of the charter and the date on which the company is reinstated). This includes any contracts the company signs, as well as any taxes that become due during that period. If a forfeited charter causes a contract to be invalid, the other party may sue the company’s principals for breach of contract or fraud. Result: multiple personal liabilities from failing to file a one-page document. Reinstating the company by paying the fee and filing the PIR does *not* provide retroactive protection.

Taxes, Oh Taxes

One of the biggest mistakes a business owner can make is to not file taxes—including federal taxes on income, Social Security, and Medicare withholdings, as well as state sales taxes and unemployment taxes. The owner is personally liable for these if not paid. The Internal Revenue Service is particularly diligent in seeking out “responsible parties” to pay the taxes, and they have the right to seize most assets the owner possesses. Responsible parties include officers who had management responsibilities and directors. The IRS generally takes the position that a person is responsible whether or not he or she actually exercised that managerial responsibility. If they latch onto you, it is very hard and very expensive to meet their demands.

The state is also fairly aggressive in seeking responsible parties, and will certainly go after a business

owner for unpaid unemployment taxes and sales taxes. The sales tax “look-back” period is three years. If a business does not collect state taxes from its customers as required, or fails to remit them to the state, all “responsible individuals” are personally liable, including officers, directors, and managerial employees who are involved in the collection, accounting, or payment of taxes.

Tax liens trump nearly all other liens and property rights, and almost all types of personal assets are subject to seizure by the federal government (excluding public benefits, alimony, and retirement accounts). The main exception is a lien for property taxes. Personal property cannot be seized to satisfy such liens, but the taxing authority may foreclose and take the property.

Case in Point

Imagine a business owner who wants to sell her business. Unfortunately, the business and the owner have both been sued. A potential buyer will not buy the company’s stock, because ownership of the stock includes responsibility for the business’s liabilities (and potentially the stock’s seizure if a personal judgment is rendered against the former owner). The buyer will not buy the assets because those assets, too, may become subject to a court judgment and seizure. The sale is off. But wait, the buyer has an idea—have the seller indemnify the buyer against any liabilities arising from the suit. Sounds reasonable, but think about what this means. Giving a personal guaranty against the liabilities of the business would mean converting a business liability (which is shielded) into a personal liability (which is not). That is a very bad idea indeed.

The Good News

Fortunately, Texas has strong laws protecting personal assets. These protected assets include the family homestead (except for property taxes, home loans, and certain other obligations), a vehicle for each driver, job tools, clothes and jewelry up to a certain amount, a Bible, and several farm animals. But look around you—do you have antiques, art, jet skis, guns, a boat, a vacation house? All of these may be subject to seizure. Asset-protection strategies can also help, but that’s a topic for another day.

As a business owner, you have worked hard for what you have. Don’t risk it all by letting down your guard. **N**

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