

Why Rishi Sunak's loan scheme cannot work and wh...

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As I [noted on this blog yesterday](#), Rishi Sunak's suggestion that £330 billion of loan funds might be made available to struggling UK businesses is entirely inappropriate for those that already face the risk of insolvency.

Under UK Section 214 of the Insolvency Act 1986, wrongful trading occurs when the directors of a company permit it to trade past the point when they:

- * knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation, and
- * they did not take every step with a view to minimising the potential loss to the company's creditors.

An example will help. Consider a company that is turning over (making sales of) £2 million a year. Its direct cost of sales (the cost of the materials that it purchases) are 35% of turnover; its labour costs are 30% of turnover and its other overheads (rent, insurance, and so on) come to another 30% of turnover. As a result 95% of its income is committed. But that still leaves it with a profit of £100,000 a year. Out of this sum £20,000 is paid in tax and £50,000 is paid in dividends to the shareholders, leaving £30,000 to be added to its retained earnings on its balance sheet. That balance sheet suggest that the company has a total net worth of £150,000 and the directors believe that this is a fair reflection of its net asset worth on a going concern basis i.e. presuming that it remains in business. They acknowledge that there would be little value if the business ceased to trade.

Now let's presume that coronavirus has effectively shut the business down, as is happening all over the UK. Sales have effectively ceased. The business is suffering from the fact that the government has told people not to come to its premises. The business will, of course, stop buying goods for resale, so there will be an immediate saving there. Let's suppose that half the overheads can be cancelled, but paying the rent and maintaining the website and paying the operating leases, and so on, cannot be cancelled. That means that the company has an ongoing commitment to spend of,

maybe, £25,000 per month, excluding wages.

With wages that increases to £75,000 per month. If all staff were to be retained the loss would, then, be of that net amount each month. That means that in two months losses equivalent to the entire net worth of the company would have been suffered. After that the company could, very easily, be insolvent. What is more, given that it is very unlikely that the coronavirus lockdown will last just two months, and the prospects for the business picking up to its old level of trading when the lockdown has ceased look to be decidedly limited given the universal impact of that downturn, the chance that the directors could reasonably conclude that they could avoid insolvency on day one of their losing almost all their turnover will be remote in the extreme. At that point it could be reasonably be claimed that they should have taken action to protect the creditors. That is most particularly true with regard to their staff, who at that point could have been due redundancy pay, with the company being able to make payment of it. Continuing without making the staff redundant, and so seeking to avoid making those payments, would, by itself, have prejudiced those employees as creditors. In my opinion the directors would, then, have been negligent.

Now just suppose that the government offers a loan of £300,000 to supposedly let this company continue to trade. What is readily apparent is that the company is in no position to accept this loan. At this precise point in time it has no trade. If they accepted the loan and used it to meet its costs, including staff, for four months then it will lose the entire sum borrowed over those same four months. At the end of that period it would be insolvent to the tune of £150,000, at least, and have no resources left to meet its obligations to the staff who would then still be redundant when the cash ran out. But now the creditors would also include £300,000 of additional borrowing. In other words, the directors would have illegally prejudiced all the existing creditors by taking the loan.

What this simple, but wholly realistic, example should make clear is that for very large numbers of companies that find themselves in this awful situation a loan is of absolutely no benefit whatsoever. It cannot save the company. It cannot preserve jobs. It might even prejudice the interests of the employees to offer such a loan now when at this moment their interest should be the absolute priority of the directors, who should be trying to make settlement of redundancy payments due to them. And what is true is that this situation is now facing companies right across the UK, from airlines to airports, to hospitality businesses, to retailers, and even car manufacturers, whose sales are going to virtually disappear for the rest of this year, at least.

When commercial wipe out is on the cards loans do not work. But nor, [as I suggested yesterday](#), can the government simply replace the missing sales: that is equally reckless, and inappropriate. What is, instead, required is support to keep the business going.

Rent, rates , tax and business loan and leasing holidays are essential. Nothing less will do.

But that still leaves the problem of staff. And the simple fact is that many businesses cannot pay their staff right now, but the cost to society of making all these people redundant is immeasurable. Which is precisely why I suggest that the government should cover the entire cost of a large proportion of the net pay due to these staff, the tax due having already been covered by a tax payment holiday. If staff are also offered mortgage and rent holidays that proportion of net pay that need be paid need not be anything like 100% of their usual net pay: 60% may be sufficient in that circumstance, and as a rule of thumb seems about right, even if (I accept) some rough justice will result, which is almost inevitable at present. It is this plan that can keep business going.

Rishi Sunak offered UK business the last thing it needed yesterday. As I have suggested, I think he did so to keep this cost off the government's deficit. He tried to put it on the government's balance sheet instead. But that was a gross error of judgement. Only the government can bear the cost of these losses. And it has to bear them if it wants to avoid the most appalling commercial catastrophe. If that is not to arise during the course of the rest of 2020 then it has to simply accept these costs now and stop pretending that they can be dealt with through loans to businesses or grants of inconsequential amount.

This then leaves the question as to whether this would work for the company that I have used in my example. I suggest that it would. All staff costs would now, in effect be covered by the government. There will be no rent to pay, no rates to pay, and no bank loan repayment necessary. That would also save some leasing costs. Overheads would, then, be slashed. Without any direct cost of sales, and with all discretionary overheads cut to the absolute minimum, this company could, then, be kept going using its own existing resources to the point in time when we could hope that the coronavirus would be over. My scheme gives this company a fighting chance. The governments gives it no hope at all. And that's what Sunak got wrong.

Crucially, this is also easy to legislate.

Bank loan repayment holidays, rent repayment holidays, rates holidays and tax deferrals can all be legislated in a day or two. And an instruction could be given to all businesses to pay 60% of net pay to staff who would otherwise be made redundant. The business would have to show why they were making that claim: excess profiteering during this period would be subject to 100% tax and director penalties after the event, I suggest as disincentive to avoid. I could draft that in a morning, and all that would then be needed would be for the PAYE scheme to go into reverse to make repayment to businesses, which is entirely possible.

And yes, the self employed would need something else, I agree.

PS With apologies for typos: this is written on a morning when I still seem to be suffering coronavirus style symptoms. I'm going back to bed now.