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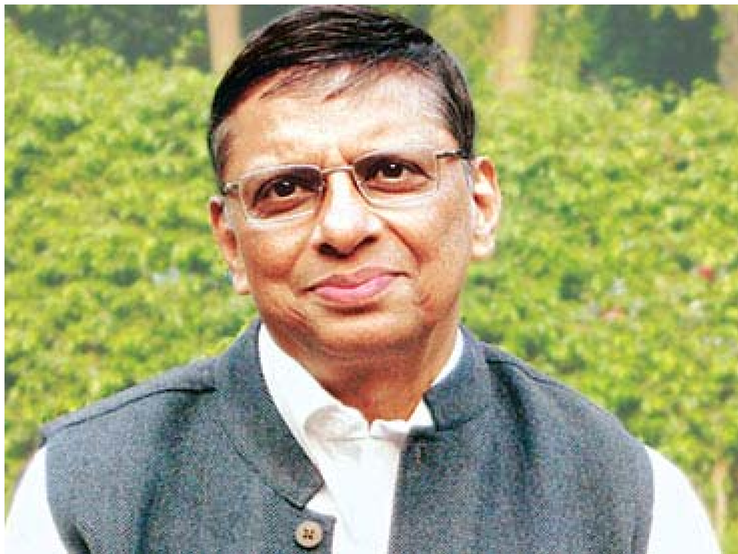
Grounding of Jet Airways: Misgovernance of family business

Expropriation of shareholders' wealth cannot be detected by applying audit procedures

Asish K Bhattacharyya **May 12, 2019** Last Updated at 22:15 IST

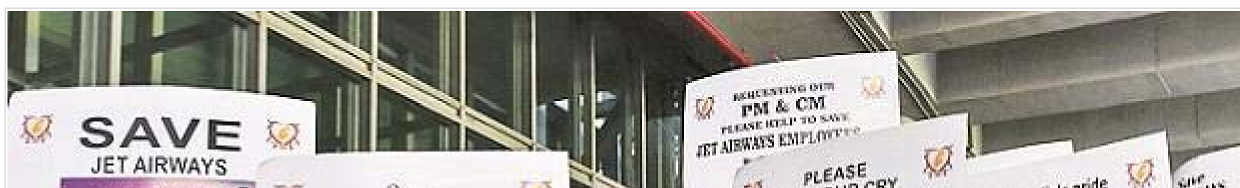


Jet Airways after flying high for the last 25 years was grounded on April 1. It failed because of poor governance.

There are two myths in the context of the governance of promoter-controlled companies. First, the promoter has skin in the game and therefore, he/she protects and creates wealth. The second is that the promoter understands the business better than outsiders (read, independent directors) and therefore, the board of directors cannot contribute to operating and financing decisions. The story of Jet Airways provides evidence that myths are myths and not reality.

The promoter's social stature grows with growth in the size of his/her empire. Therefore, the promoter often focuses on empire building and not on wealth creation. The acquisition of Air Sahara by Jet Airways in 2006 should be seen as an empire building activity of Naresh Goyal. It is reported that he acquired Air Sahara against the advice of aviation experts to satisfy his arrogance and ego. Many experts believe it was the beginning of the downfall of Jet Airways.

In a family business, the promoter calls the shots when it comes to strategic decision making. When industry faces disruption due to the emergence of new technology or changing customer profile or the emergence of a new business model with the entry of new players, the promoter might fail to fully grasp the changing context. In a family business, the board is not independent in its true sense and acts like a 'yes man'. It seldom challenges the promoter's strategy. Moreover, the promoter's aspiration, arrogance and ego put a blinder on his/her eyes and plugs in ears. Therefore, he/she fails to see and listen to signs of disruption coming. Goyal failed to appreciate that two distinct business models — full-service model and no-frills, low-cost model — do not work parallelly within the same organisation. Jet Airways had started low-cost airline (Jet Lite) after the acquisition of Air Sahara and stopped flying the same after some years of operation when it was too late. He also could not appreciate that Jet's market share was dwindling due to an increasing market share of low-cost airlines. As a result, he messed-up the business.



Research has

Jet Airways

established that in a family business, syphoning of funds is quite common. Therefore, regulators formulate regulations to protect non-controlling shareholders from abusive party transactions. But the controlling shareholder expropriates shareholders' wealth through various other means, such as disproportionately high compensation, appointing family members in high positions with high compensation without any responsibility and through underhand dealings. The promoter accumulates huge private wealth during heyday and often withdraws the equity capital he/she invested in the business. The beauty of the company form of organisation is that personal wealth remains intact even if the business fails. Many commentators suspect that Goyal accumulated personal wealth using unethical means. Although in no situation that can be verified. Regulators take severe actions against auditors due to their inability to detect fraud, as they often accept management versions when they detect irregularities. Regulators had taken penal action against PwC and are contemplating taking penal action against Deloitte in the case of IL&FS. Tightening the auditing profession is expected to improve audit quality. However, the expropriation of shareholders' wealth cannot be detected by applying audit procedures.

One might wonder how, with so many governance challenges, family businesses outperform their peers. One of the reasons is that professionally managed firms have their own governance challenges — primarily agency problem and short-termism. Promoter reduces the agency cost by monitoring the manager effectively and takes a long-term view. Moreover, a firm that belongs to a business family focuses on protecting and creating wealth. This is so because a business family, which is in business for a few generations and has already built a business empire, enjoys the social reputation for its ability to protect and create wealth. Corporate governance issues in a promoter-driven company exposes non-controlling shareholders' investment in equity to high risk mostly in firms that do not belong to a business group or that operates in a difficult industry (such as airlines) or during an era in which disruptive forces emerge too frequently or when the firms are controlled by the second or next generation scion who does not have the same business acumen that was demonstrated by the founder.

In recent times, many business groups address the governance challenges by adopting a governance model in which the family plays the role of a supervisory board and leaves the management to professional managers and an independent board.

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