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Himachal Fertilizer Corporation (A): An Ethical Conundrum

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Himachal Fertilizer Corporation (hereafter, HFC, or the Company) was a large publicly listed corporation in India engaged in the production and marketing of urea. Urea is a chemical compound most commonly used as a nitrogen fertilizer in the agricultural and polymer industries. Available as free-flowing prills (granules), it is the cheapest form of fertilizer to transport and the least likely to "cake." It is therefore favored in developing countries such as India.

With revenues of over US$ 9 billion and net income of over US$ 500 million in 2011, HFC had operations and offices spread across the country. The Company was in the process of setting up a plant in Central India, with a capacity to process five million metric tons of naphtha (a flammable liquid made from distilling petroleum) that it would use as the feedstock for producing urea. The new plant would increase its existing production capacity of about 33 million metric tons by 25 percent.[1] The naphtha was to be received from East Asia via large tankers, offloaded at a port, and transported through a pipeline to HFC's manufacturing plant for processing.

In March 2012 HFC had floated a tender (i.e., invited bids) to handle imported naphtha for its upcoming plant. Given the sizeable volume of naphtha to be handled, the bidder port that would be awarded the contract would be required to make significant additional investments in new facilities, including setting up a single buoy mooring (SBM)[2] for offloading of naphtha from the tankers, constructing pipelines to carry naphtha onshore from the SBM, and installing storage tanks to store the naphtha before being transported to the plant. HFC would construct and operate the pipeline to transport naphtha from the storage tanks to the plant and obtain necessary environmental clearances from the states through which the pipeline would pass.[3]

The investment to be made by the bidder port was expected to be US$ 120 million. HFC and the port would sign a contract that would guarantee a minimum cash flow to the port for an initial period of twenty years, with an option to renew the contract

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for another ten-year period on mutually agreed terms (see **Exhibit 1** for the details of financial evaluation of the contract.)

Exhibit 1: Financial Evaluation of the Contract to Handle Naphtha

Item	Amount	Unit
Capacity of plant	8.25	Million metric ton per year
Naphtha required*	5	Million metric ton per year
Estimated handling charges for naphtha	6	US$ per metric ton
Operating cost of facilities for naphtha	0.40	US$ per metric ton
Discount rate for computing present value	10%	
Present value of pre-tax cash flows @ 10%	238	Million US$
Additional investment in facilities	120	Million US$
Net present value of the contract (before-tax)	118	Million US$

* Assumes that a 1.65 million metric ton plant requires about one million metric ton of naphtha.

The net present value of the contract, ignoring taxes, was about US$ 118 million, based on the cash flows in the first twenty years. Since the costs of the bidder would mostly be incurred in Indian Rupees (INR), if US$ were to appreciate against the Rupee, the contract would become even more valuable. The salvage value of the facilities at the end of the twenty-year period would further boost the bidder's financial returns. Given the global recessionary situation continuing to prevail in 2012, the contract would be a lifeline for the winner of the contract. HFC therefore expected the rates[4] quoted by bidding ports to be very competitive.

The tender documents had been obtained by five companies upon payment of the requisite fees. Although any port in the country was free to bid for the contract, realistically, due to their proximity, only two ports, one located on the Southern coast of India, owned by India Ports Limited (IPL), and another located on the Western coast of India, owned by Bharat Ports Limited (BPL), were expected to be serious contenders.

Evaluation of Bids

Potential bidders were given approximately four weeks to submit their bids. The deadline for bid submission was 5:30 p.m. on April 14, 2012. The bids were to be evaluated by a team of executives from the logistics division of HFC and then presented to the investment committee (of the board), which comprised three HFC board members. The Committee was tasked with the selection of the winning bid and recommending a decision to the board. The recommendation of the investment committee would be discussed in a meeting of the full board for a final decision on awarding of the contract. The investment committee was scheduled to meet on April 20, 2012, and the presentation from management was to be led by Mr. George Mathew, director (logistics).[5]

George Mathew, a mechanical engineer by profession, was a long-time executive in the Company. He had risen through the ranks and had been with the logistics division throughout his career at HFC. Perceived as a "tough" boss, subordinates respected his technical competence. He demanded absolute obedience from his subordinates. George was articulate and expressed his views boldly and with conviction. He was not a person who would give in easily to those opposed to his views.

The investment committee was chaired by Mr. Anil Nair, a non-executive independent director with vast corporate experience. The other members of the committee were Mr. Neil Shah who was also a non-executive independent director on the board, and Mr. Surendra Rawat, director (finance) of HFC. Neil and Anil had developed an excellent working relationship over the six years they had been on HFC's board. Both of them had joined the board on the same day and had worked together on several challenging issues.

Neil was a chartered accountant with over two decades of corporate board experience. He had recently retired from active service as director (finance) of a large multinational corporation. After retirement, he operated from an office located in Mumbai, advising companies on issues connected with strategy and governance. He had been inducted into the board of HFC following wide-spread reforms in corporate governance implemented by the Indian government (**Appendix A** provides a brief history and current state of corporate governance in India). The boards of listed companies were required to have a minimum of one-third non-executive independent directors. Neil was well-respected in the corporate world on the strength of his professional standing. Neil chaired the audit and ethics committee of the HFC board.

The Meeting on April 15

On April 15, 2012, Neil received a telephone call around 10 a.m. from Mr. Paul Joseph, who identified himself as general manager with India Ports Limited (IPL). "Good morning, Sir," the caller began. "Sorry to bother you, but I need to meet with you urgently on an important matter regarding the irregularity in the tender process for handling naphtha for HFC. It merits your urgent attention."

The words "irregularity in the tender process" raised Neil's antenna. As a member of HFC's board, he wanted to ensure that the due process was not compromised on such an important contract for HFC. However, he was also concerned that meeting with the caller might violate HFC's Code of Conduct[6] for directors and executives. "I don't think it is a good idea. Wouldn't it be inappropriate for me to meet with you given that IPL is one of the bidders for the contract to handle naphtha?"

"Sir, I would like to apprise you of a serious irregularity in the process for selecting the bidder for the contract. In fact, we have been disqualified through a sudden change in the process that was made to favor a specific bidder. The situation and the irregularity can be best explained in a personal meeting," said Paul. "We decided to approach you since you are the chair of the audit and ethics committee of the board. We do not know how else to deal with the situation."

Neil was unsure of how to respond. The mention of his role as the chair of the ethics committee strengthened his urge to do the right thing, and before he realized, Neil agreed to meet Paul. Before disconnecting, he cautioned Paul, "If I find that you are even indirectly trying to solicit my support for IPL's bid, I will have IPL disqualified from participation in the bidding on grounds of attempt to influence the process unethically."

In less than thirty minutes, Paul was in Neil's office.

Paul began the conversation by saying, "Sir, a key bid condition was changed at the last minute to disqualify us. At around 1:00 p.m. yesterday, we received a fax message from HFC that the deadline for submission of sealed bids had been advanced from 5:30 p.m. to 3:00 p.m. We made frantic efforts to reach the HFC office by this new deadline but were unable to do so. Although we presented our bid at 4:30 p.m., it was rejected because it was submitted after the new deadline. We are extremely upset that our bid was not accepted."

Neil was puzzled by the assertion that advancing of the deadline by a few hours was being characterized as a "serious breach" of the bidding process when four weeks had been given for bid preparation. He asked Paul, "I do not understand why advancing the deadline by a couple of hours would be of significant consequence. You had several weeks to submit your bid. Why would you wait until the last minute to submit it?"

"Sir, let me explain. Because the bids are required to be delivered in person, the bids are submitted by a senior and trusted employee. We intended to submit it just before the deadline to minimize the possibility of the information being surreptitiously made available to the other bidders. In our case, an executive director was assigned the task of submitting the bid. He was to drive down to Bangalore to submit the bid by 5:00 p.m. As soon as we received the fax informing us that the deadline had been advanced, we contacted him. Despite frantic efforts, he reached the headquarters of HFC at 4:30 p.m., well after the new deadline had expired. We understand that HFC has received only one bid—from BPL. We believe that BPL was informed in advance about the change in deadline and that the change was executed in a manner that would exclude us from the bidding process," explained Paul.

Neil had always been uneasy about decisions involving large contracts. The high stakes involved created significant incentive for unethical behavior. However, providing advantage to a bidder through an apparently innocuous deadline change was new to him.

"Sir, we feel that BPL may have promised to compensate some managers in return for favorable treatment," added Paul, "particularly those involved in evaluating the bids, such as Mr. George Mathew."

Neil responded, "I do not mean to impugn the reputation of your company but isn't it possible that IPL, too, attempted to bribe management but couldn't strike a deal with HFC?"

Paul responded, "Sir, we are a company that observes the highest standards of probity in our functioning. If you permit, Mr. Nitin Advani, the promoter[7] of our company, would be happy to speak with you. You can see for yourself that he is a businessman with strong ethical values."

Neil was anxious. He could not decide immediately on what he should do. He realized that he had perhaps already put himself in a compromising situation by meeting Paul. Meeting Mr. Advani would only make things worse. He said to Paul, "No, there is no need for Mr. Advani to meet me. Let me see what to do with the information you've provided."

"Sir, you have to help us out. We have state-of-the-art port facilities that are much better than BPL's facilities. I can assure you that we would serve the needs of HFC better than BPL because we specialize in handling liquid cargo, which is what this tender calls for. And sir, we would have understood if our bid had been rejected because it was not competitive, but being denied an opportunity to participate in the bid through such devious means is entirely unfair," pleaded Paul.

Neil said, “I understand your concern. Let me think it over.” Just as he was about to leave, Neil called Paul back and asked, “If what you are saying is indeed true, then why did you not complain in writing to the Company?”

“Sir, we have already sent a letter to HFC explaining why our bid could not be submitted before the revised deadline. We have requested that since the deadline was changed with such short notice, our bid should be accepted. We fear that our request will be denied,” said Paul.

Neil was unsure how to deal with the information that Paul had provided. One course of action would be for him to disclose to the committee before the meeting that he had met an executive from IPL, and that this executive had conveyed information that might have a significant bearing on the integrity of the bidding process. Another option was to mention it informally to Anil Nair (chair of the committee). Neil also considered doing nothing and waiting to see how events unfolded in the investment committee meeting.

Appendix A: Note on Corporate Governance in India

Although some governance and disclosure standards were required by the Companies Act of 1956, the real momentum for corporate governance in India gathered steam during the country's process of liberalization in 1990s. In 1998, the Confederation of Indian Industry (CII) issued a voluntary code called Desirable Code of Corporate Governance. In 1999, the Securities and Exchange Board of India (SEBI)—a regulating body similar to the Securities Exchange Commission in the U.S.—set up a committee chaired by Kumar Mangalam Birla to raise the standards of corporate governance. Later it set up another committee chaired by N. R. Narayana Murthy for formalizing the best practices on corporate governance. The Murthy committee defined corporate governance as follows in its report:[8]

> Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.

Based on the suggestions of the Birla and the Murthy Committees, and the Sarbanes Oxley Act of 2002 in the U.S., Clause 49 was modified by SEBI as part of the listing requirements for the companies listed on Indian stock exchanges. SEBI noted that the Indian Corporate Governance Framework is in compliance with the Corporate Governance Principles of OECD (Organization for Economic Cooperation and Development). Later, in the aftermath of India's biggest corporate fraud (Satyam) in 2008, SEBI issued requirements pertaining to disclosure of pledged shares, peer review of the working papers of audits, maintenance of website, compulsory dematerialization of promoter holdings, approval of CFO by the audit committee, enabling shareholders to cast vote electronically, etc.

Code of Conduct for Board of Directors

The board of directors section of Clause 49 (as at the time of episodes described in the case) also included the following provisions regarding the code of conduct for the board members and senior management:

1. The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.
2. All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.
3. An independent director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.

Additional regulatory changes were expected in the area of corporate governance that would bring practices in India closer to practices in the U.S. and Europe.

Notes

1. One metric ton of naphtha is required to produce about 1.65 tons of urea. Thus, five million tons of naphtha would service a urea plant of about eight million tons.
2. SBMs are off-shore floating platforms, with limited storage capacity that are used to empty liquid cargo such as crude and petroleum products from ships that are too large to dock at ports. The cargo is pumped by pipelines from the SBMs to large onshore storages.
3. The time for obtaining environmental clearances would vary depending on the number of states through which the pipeline from the port to the plant would pass.
4. The rates were to be quoted per ton of Naphtha handled.
5. Director (logistics) was a whole time (i.e., full-time) director on the board of HFC.
6. The Code of Conduct of HFC laid down broad standards of compliance and ethics, as required by Clause 49 of the Listing Agreement with the Bombay Stock Exchange and the National Stock Exchange. The ethical conduct section of the Code required officers and directors to (a) fulfill their fiduciary obligations without allowing their independence of judgment to be compromised; (b) act fairly and transparently and not participate in any subject matter in which a conflict of interest is likely to exist such that an independent judgment of the Company's best interest cannot be exercised; (c) not engage in any business, relationship or activity with anyone who is a party to a transaction with the Company; and (d) avoid any dealings with a contractor or supplier that compromise the ability to transact business on a professional, impartial and competitive basis, or influences decisions to be made by the Company.
7. Promoters are the founders of a company. They typically occupy senior executive positions in the company, and are members of the board of directors.
8. Available at http://www.sebi.gov.in/commreport/corpgov.pdf