THE MANAGMENT OF IRREGULARITIES IN PUBLIC PROCUREMENT AND THE APPLICATION OF FINANCIAL CORRECTIONS

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CONTENTS

GLOSSARY

EU	European Union
CMD	Council of Ministers Decree
MA	Managing authority
OP	Operational programme
GC	Grants contract
MRESIFA	Managing of Resources from the European Structural and Investment Funds Act
ESI Funds	European Structural and Investment Funds
EC	European Communities
PPA	Public Procurement Act, in force as of 15.04.2016
MDFC	Methodology on determining financial corrections with regard to violations found in the award and performance of public contracts and contracts under projects, financed by the Structural Funds, the Cohesion Fund of the European Union, the European Agricultural Fund for Rural Development, the European Fisheries Fund and funds of the General Programme "Solidarity and Management of Migration Flows[1]"
CM	Council of Ministers
TFP	Transitional and final provisions
Regulation (EU) No 1303/2013	Regulation (EU) No 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006
SAC	Supreme Administrative Court

[1] Adopted with CMD No. 134 of 05.07.2010 (title amended with SG, issue No. 52 of 2014, in force as of 24.06.2014).

Ordinance on managing irregularities (2007 - 2013)	Ordinance on managing irregularities under European structural and investment funds[2]
Ordinance on managing irregularities (2014 - 2020)	Ordinance on managing irregularities under funds, instruments and programmes, financed by the European Union[3]
ECJ	European Court of Justice
Regulation 2988/95	Council Regulation (EC, EURATOM) No 2988/95 of 18 December 1995 on the protection of the European Communities financial interests

[2] Adopted with CMD No. 285 of 30.11.2009 (title supplemented – SG, issue No. 6 of 2012).

[3] Adopted with CMD No. 173 of 13.07.2016

LIST OF FIGURES

1. BACKGROUND[i]

The historical overview of the Bulgarian legislation on the public relations regarding registering, managing and detecting irregularities and determining and applying financial corrections related thereto, in connection to granting and implementation of financial support from the structural funds of the European Union, indicates the presence of significant development over the years. The basis of the applicable legal regime is laid down with the adoption of CMD No. 119 of 30 May 2008 on the rules, procedures and mechanism for withdrawing unduly paid and overpaid amounts, as well as for unlawfully obtained or improperly implemented resources by budgetary and state undertakings from pre-accession instruments, EU funds, as well as nationally co-financed or pre-financed instruments. Within the scope of this first legislative act simultaneously fall both the rules on reporting and managing irregularities and the rules on their impact execution (procedures and mechanism for withdrawing unduly paid and overpaid amounts, as well as for unlawfully obtained or improperly implemented resources). Subsequently, Ordinance on managing irregularities under European structural and investment funds (Ordinance on managing irregularities (2007-2013) was adopted in 2009, which is entirely focused on the procedures for managing irregularities.

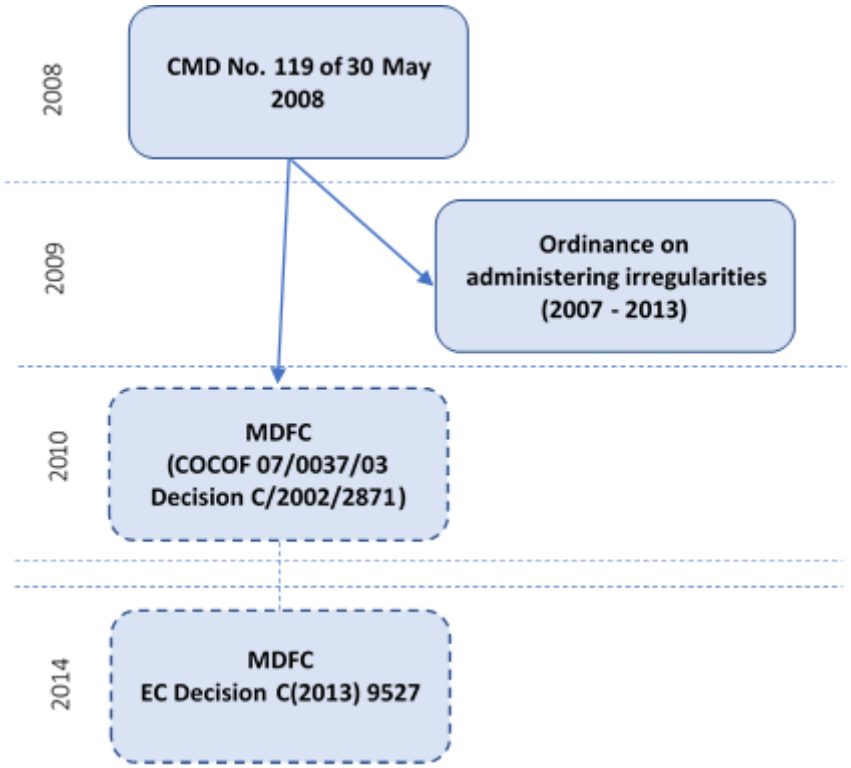
In 2010 the next step in the development of the legal framework was made with the adoption of the Methodology on determining financial corrections with regard to violations found in the award and performance of public contracts and contracts under projects, financed by the EU funds" (MDFC). The following general rules were established with the first version of the Methodology:

- Guidelines for determining financial corrections to be made to expenditure, co-financed by the Structural Funds or the Cohesion Fund for non-compliance with the rules on public procurement (COCOF 07/0037/03); and
- EC Decision C/2002/2871.

With the next significant revision of the Methodology in 2014, the MDFC implements the guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement, adopted with Commission Decision C (2013) 9527 of 19.12.2013.

Despite the availability of legally regulated mechanisms supporting the detection of irregularities and the recovery of unduly paid amounts, their implementation has been significantly impeded due to the legal lacuna and the uncertainty about the legal nature of the grants contracts within projects financed with EU funds. The analysis of the case law indicates that for the period between 2010 until the end of 2015, the GC have been perceived as relations with contractual nature and in this sense – the implementation of financial corrections as a result of irregularities shall be considered dependent to the general rules of civil and civil procedural law.

Figure 1. Development of the legal framework 2007 - 2014



This statement is also supported by the fact that no administrative relation exists to regulate the relationships between the managing authority and the beneficiary[4] on the basis of a hierarchical or statutory subordination between them. In this sense, the relationship between the parties should be viewed in light of the civil law, as long as there is subordination between them. SAC Interpretative Decision No. 8/11.12.2015 in interpretative case No. 1/2015 is the first major breakthrough in both the established understanding and the case law, in which SAC defines that GS have an "administrative contract" nature, and the MA's statements, related to the application of financial corrections, have "individual administrative acts" nature. Subsequently, this understanding of the supreme judges was legitimately implemented in the MRESIFA, in force as of 25.12.2015.

As for the MRESIFA, by its adoption the legislator aims:

- to respond to the urgent need for a clear legal framework defining the nature of public relations related to carrying out programs funded by the ESI Funds;
- to establish the rights and obligations of the participants in the process;
- to eliminate the existing fragmentation of the legislation;
- to codify and unify the applicable procedures; etc.

[4] With regard to the wrong use in the Bulgarian legislation of the term "beneficent" instead of the correct one "beneficiary", see "Beneficent VS. Beneficiary", Kostova, M. Europe Getaway (http://europe.bg/); Decision No 9251 of 27.07.2016 in administrative case No 6588/2016 of SAC; and Decision No 9404 of 02.08.2016 in administrative case No 5692/2016 of SAC.

The Act governs the general principles, related to the overall management of ESI Funds resources, incl. the procedures applicable to detecting irregularities, determining and challenging financial corrections. Although the MRESIFA terminated the ongoing discussion about the nature of the relationships existing within the GC, the questions concerning the nature of the irregularities and the financial corrections, the effect of the law in time, its scope and application, became particularly viral.

Along with the MRESIFA, MDFC and the Ordinance on managing irregularities under funds, instruments and programmes, financed by the European Union (Ordinance on managing irregularities (2014-2020), the public relations with regard to management, granting, implementation, reporting and verifying the expenditure of resources from ESI Funds for the period 2014 – 2020, fall also within the scope of the:

- Internal Audit in the Public Sector Act;
- CMD No. 189 of 28.07.2016 laying down national rules on the eligibility of expenditure under programs financed by the EU Structural and Investment Funds, for programming period 2014 - 2020;
- CMD No. 162 of 07.05.2016 laying down detailed rules for granting financial aid under programs financed by the EU Structural and Investment Funds for the period 2014 - 2020;
- CMD No. 160 of 07.01.2016 laying down the rules for the examination and evaluation of tenders and the contracting procedure with a public call by beneficiaries of grants from the EU Structural and Investment Funds.

2. NATURE OF IRREGULARITIES WITHIN THE AWARD OF A PUBLIC CONTRACT

The term “irregularity” was defined for the first time in the Bulgarian legal system with the adoption of the Financial Management and Control in the Public Sector Act[5]. According to that definition, an “irregularity infringing the financial interests of the European Communities” is any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure. This definition is adopted from the content of Regulation (EC, EURATOM) No 2988/95 on the protection of the European Communities financial interests and is currently still used without any substantial semantic amendments, incl. for the purposes of other legislative acts[6]. In this sense, according to the current versions of the applicable regulations, an “irregularity” within the context of ESI Funds means “any breach of Union law, or of national law relating to its application, resulting from

[5] Promulgated, SG issue No. 21 of 10 March 2006.

[6] In this sense see Regulation (EU) No 1303/2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006; Managing of Resources from the European Structural and Investment Funds Act; Ordinance on managing irregularities under funds, instruments and programmes, financed by the European Union; Ordinance on managing irregularities under European structural and investment funds; etc.

an act or omission by an economic operator involved in the implementation of the ESI Funds, which has, or would have, the effect of prejudicing the budget of the Union by charging an unjustified item of expenditure to the budget of the Union". In accordance to that definition, irregularities' basic characteristics could be outlined as follows:

- **firstly**, an irregularity is a breach of the Union law or the Member State law;
- **secondly**, the irregularity may result from both an act or an omission;
- **thirdly**, the irregularity should be a result from the unlawful behavior of an economic operator (an economic entity), which participates in the implementation of the EU structural and investment funds. An economic operator is any natural or legal person or other entity taking part in the implementation of aid from the ESI Funds, with the exception of a Member State exercising its prerogatives as a public authority. It should be noted that despite the fact that contracting authorities are public entities within the meaning of PPA, in their capacity as beneficiaries of financial aid from ESI Funds, they fall under the definition of an "economic operator" on the basis of the respective GC;
- **next**, the act or omission should or would have the effect of prejudicing the common budget of the Union. In this sense, it is not necessarily for the irregularity to have led to real loss. An irregularity may exist even when there is a possibility of affecting the budget and there is no requirement to a specific and/or real financial value[7]; and
- **lastly**, the irregularity should be related to the accrual of irregular expenditure in the Union budget.

Thus defined, the irregularity could be single, but could also have a recurring nature, with a high probability of occurrence in similar types of operations due to serious deficiencies in the effective functioning of a management and control system, including a failure to establish appropriate procedures in accordance with the general or special rules for ESI Funds. The European legislator defines these cases as a "systemic irregularity"[8].

Given the aforementioned, it could be concluded that an irregularity in awarding public contracts means any violation of the Union law governing public procurement or the national law, related to its implementation, which results from an act or omission by a contracting authority within the meaning of PPA[9], upon the award of a public contract, which performance is entirely or partially financed by the ESI Funds, and which affects or would affect the Union budget by the accrual of irregular expenditure in the Union budget. In this sense, irregularity would be the violation of Directives 2014/24 and 2014/25[10], as well

[7] This interpretation of the provision is permanently established in the ECJ case law on the question of identical definitions in Regulation No 2988/1995, Regulation No 1083/2006, as well as in other sectoral regulations. In this sense see ECJ Judgement in Cases C-199/03, (p. 31); C-465/10; (p. 470); C-406/14 (p. 44).

[8] The differentiation between "single" and "systematic" irregularity is related to their consequences. A single irregularity would lead to decommitment of partial or complete financial support within one GC (project), while a systematic irregularity would lead to decommitment of the funding in the whole operational programme.

[9] The main categories of irregularities (violations) and the recommended amounts of the respective financial corrections are laid out in Enclosure to Art. 6, Para 1 to the MDFC.

[10] Directive 2014/24/EC on public procurement and repealing Directive 2004/18/EC; and Directive 2014/25/EC on procurement by entities operating in the water, energy, transport and postal services sectors and repealing Directive 2004/17/EC.

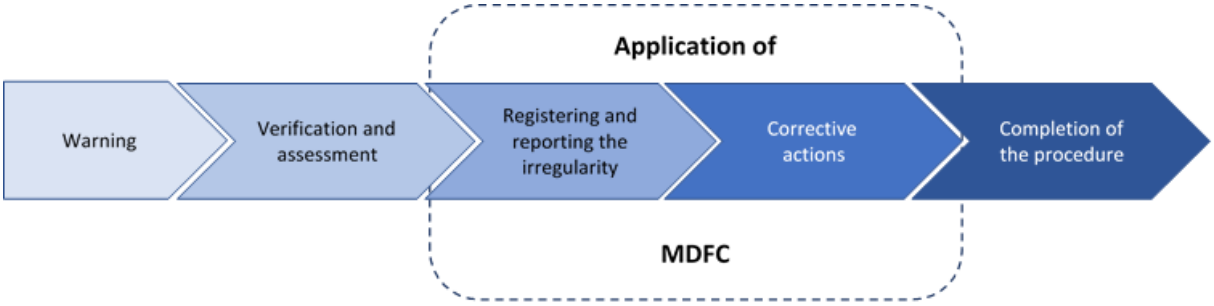
as the violation of the national provisions of PPA, incl. with regard to public contracts which are below the thresholds determined with the directives[11]. It is necessary the public contract to be awarded within a GC (a project) in order to consider the violation of the rules for selecting a contractor as an irregularity.

3. MANAGING IRREGULARITIES

With regard to the legal provisions for managing irregularities, the following are applied: Ordinance on managing irregularities (2007 - 2013) and Ordinance on establishing the procedures for managing irregularities (2014 - 2020), depending on whether it is a GC implemented within a project, financed under an operational programme in the period 2007 – 2013, or in the period 2014 – 2020. Nevertheless, in both cases the process (procedures) for managing irregularities remains relatively the same in its nature.

The management of irregularities consists in the detecting of irregularities, their entry into registers specifically designed for that purpose, their reporting and further follow-up of the respective case. Prior to identifying an irregularity, however, it should be reported (i.e. a warning should be submitted). A warning could be given by any person; and the employees of entities, managing European funds, instruments and programs, are obliged to do so in any case. The warning could also be anonymous. Any person, who have submitted a warning, is entitled to protection against dismissal or any other adverse effect based on the fact that the said person has submitted a warning. Upon a warning and a research conducted by the competent authorities (incl. the court), the same prepare a statement, which ascertains the presence or lack of an irregularity. This represents also the first written assessment of the case and should be motivated. Thus, the irregularity has been detected and should be entered into the register of irregularities. It should be noted that the written conclusion may subsequently be revised or revoked during the administrative or judicial procedure.

Figure 2. Process of managing irregularities



In relation to the registration of irregularities, the entities, managing European funds, instruments and programs, are obliged to maintain a register for all warnings received, the information of which is periodically submitted to Directorate “Protection of the European Union Financial Interests” (AFCOS) at the Ministry of Interior. For any case of irregularity, which are subject to notification to OLAF, AFCOS collects and analyses the information needed, and sends it to OLAF within two months, as of the end of each quarter. AFCOS immediately notifies OLAF for cases which represent a new illegal practice or could have a rapid impact outside the territory of the country.

[11] See Art. 4 of Directive 2014/24 and Art. 15 of Directive 2014/25.

The regime of managing irregularities is directly related to and incorporates the implementation of the legal consequences of any detected irregularity – imposing a financial correction.

4. LEGAL NATURE OF FINANCIAL CORRECTIONS

From the provisions of MRESIFA and Regulation (EU) No 1303/2013 it could be concluded that:

- the application of a financial correction is a direct consequence of an established violation of the Union law and/or the Bulgarian legislation; within the context of public procurement, the irregularity and the financial correction as a consequence thereto, will be related to an established violation of directives 2014/24 and 2014/25 and/or PPA;
- the financial corrections' objective is to achieve or restore the situation where all expenditure certified before the EC comply with the applicable EU and Bulgarian legislation;
- financial corrections lead to the decommitment of the financial support provided with resources from the ESI Funds; the financial correction's merits and amount are determined with a motivated decision by the director of the MA[12], who has approved the project; this decision constitutes an individual administrative act and is subject to appeal under the rules of the Administrative Procedure Code;
- the decommitment of the granted financial support could be complete or partial – for the entire project, for particular activity, for a contract or for certain expenditure;
- a financial correction could be applied only once – it is not admissible for the one and same irregularity to apply a few financial corrections;
- the total amount of applied financial correction within one GC (project) could not exceed the amount of the granted financial support under it.

The aforementioned characteristics of the financial correction are derivatives from its application and do not define its nature. In this sense, the analysis on the applicable case law shows that the Bulgarian court often determines the financial correction as a specific form of administrative sanctions. Indeed, Regulation 2988/95 states that the establishment of a financial correction may lead to imposing administrative sanctions[13]. This understanding,

[12] Pursuant to Art. 9 of MRESIFA the director of MA is the director of the administration or entity within which structure the managing authority is positioned, or a person authorized by him. It should be noted that the provision of Art. 73, Para 1 of MRESIFA does not provide for delegation of powers by the director of the administration. In this sense, it could be concluded that with regard to the issuance of a decision determining the financial correction, the director of the administration has sole competences (in this sense see Decision No. 1485 of 25.08.2016 in administrative case No. 811/2016 of Administrative Court – Burgas).

[13] Indeed Art. 5, Para 1 of Regulation 2988/95 envisages the possibility of imposing administrative sanctions, which consist of: payment of an administrative fine; payment of an amount greater than the amounts wrongly received or evaded, plus interest where appropriate; total or partial removal of an advantage granted, even if the operator wrongly benefited from only a part of that advantage; temporary withdrawal of the approval or recognition necessary for participation in an aid scheme; loss of a security or deposit provided for the purpose of complying with the conditions laid down by rules or the replenishment of the amount of a security wrongly

however, is not correct. The nature of the financial correction has been subject to interpretation by the ECJ, that in its Judgement in Joined Cases C-260/14 and C-261/14 stated that "financial corrections by Member States, if applied to co-financed expenditure under Structural Funds for failure to comply with rules concerning the award of public contract, **are administrative measures within the meaning of Article 4 of Regulation No 2988/95**". These measures consist of:

- withdrawal of the wrongly obtained advantage by an obligation to pay or repay the amounts due or wrongly received; or
- total or partial loss of the security provided in support of the request for an advantage granted or at the time of the receipt of an advance14.

It worth noting that imposing the generally defined in Regulation 1988/95 sanctions could not be conducted only on its basis. In order to implement such administrative sanction, prior to occurrence of the irregularity it is needed:

- the European legislator to have adopted sector legislation which defines the respective sanction and the conditions for its imposing on the specified group of persons; or
- in case such sector legislation has not been adopted at EU level – the Member State legislation, where the irregularity has occurred, to have envisaged the imposing of an administrative sanction on this group of persons[15].

Currently, neither the European, nor the Bulgarian legislation provides for the implementation of an administrative sanctioning liability in relation to irregularities in the context of ESI Funds. The aforementioned indicates that the financial corrections are *sui generis* administrative measures whose application is directly based on the provisions of the Community legislation and is implemented under the rules and procedures, laid out in the national legislative systems on the basis of the EC guidelines. It should be noted that despite of some similarities between them, the financial corrections deviate from the traditional understanding of "compulsory administrative measures", established in the Bulgarian administrative and administrative sanctioning doctrine. Therefore:

- both financial corrections and compulsory administrative measures represent a form of administrative constraint;
- both financial corrections and (restorative) compulsory administrative measures are aimed at recovery – under an administrative procedure – of unlawfully amended factual situation and thus, at repealing the actual negative consequences occurred due to the violation.

However:

released; other penalties of a purely economic type, equivalent in nature and scope, provided for in the sectoral rules.

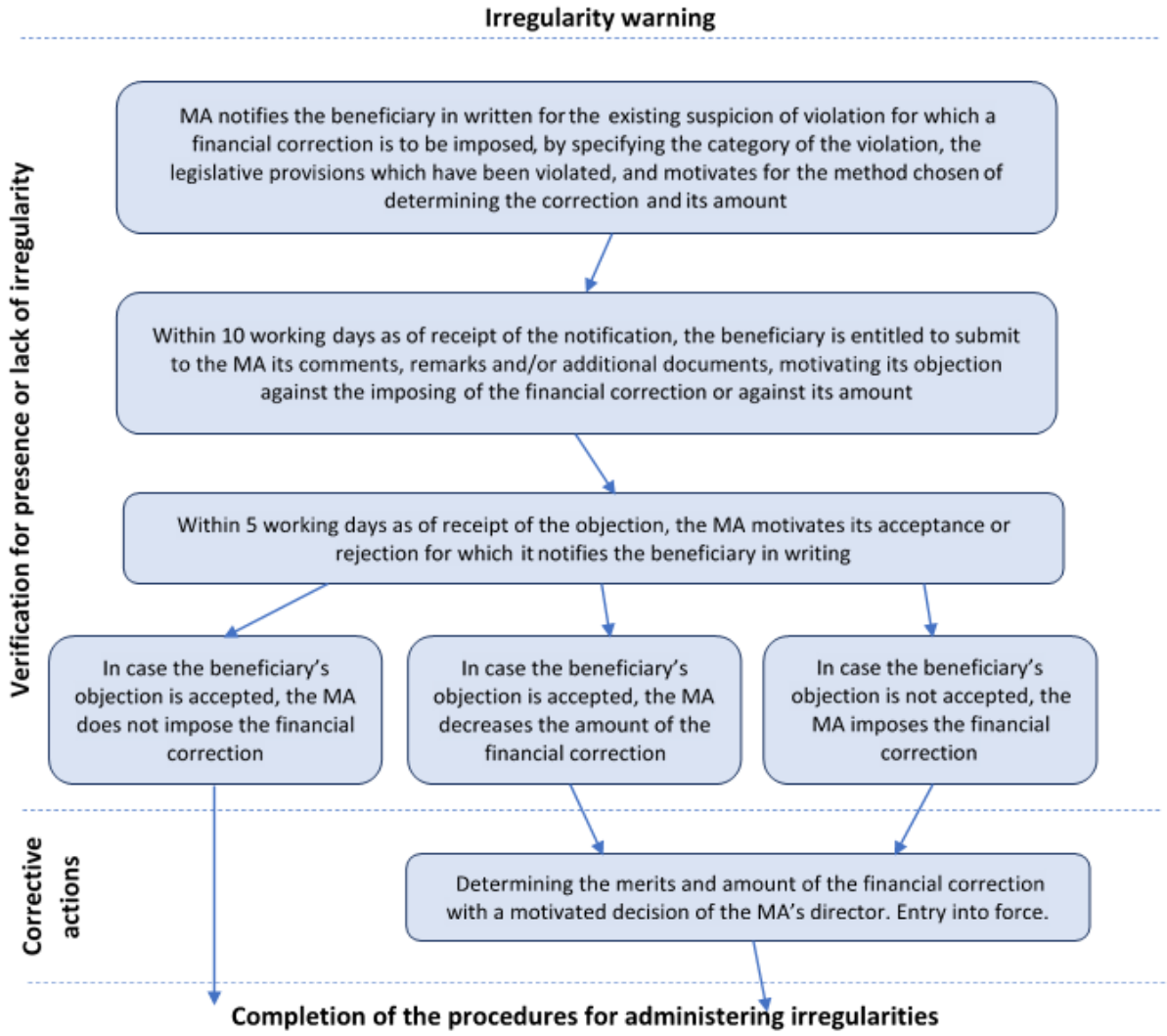
[14] Art. 4, Para 4 of the Regulation explicitly states that the measures provided for in it should not be regarded as sanctions.

[15] In this sense see ECJ Judgement in Case C-367/09.

- the compulsory administrative measure relates to the application of the core of the sanctioning (administrative sanctioning) rule. As seen above the financial correction is not related to the implementation of administrative sanctioning liability. Therefore, the lack of a sanctioning part in the rule, leads to the lack of a rule itself.

Thus, financial corrections should be deemed as a separate type of administrative constraint, apart from the administrative sanctions and the compulsory administrative measures.

Figure 3. Process of determining a financial correction



[i] This Policy Paper was developed and written by Boyan Ivanov and Radina Tomanova on behalf of *Dimitrov, Petrov & Co* under the direction of Paulo Magina, Head of the OECD Public Procurement Unit and Petur Berg Matthiasson, Policy Research and Advice, OECD Public Procurement Unit with contribution from Zdravka Pekova, Local Coordinator for the OECD in Bulgaria for this project.