

FINANCIAL CORRECTION APPLIED IN CASE OF IRREGULARITY

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1. INTRODUCTION

Rules regarding the use of financial supports provided by the European Union might be infringed and in practice they are actually infringed; the complete investigation of such activities are served by irregularity procedures. If it is established in the course of such procedure that the financial support has not been properly used in accordance with the law or the contract, it results in serious legal consequences for the beneficiary (the winner of the tender) and may also jeopardize the financial interests of the European Union and Hungary.

In the present study the author puts emphasis on the demonstration of the most serious legal consequence, namely the (partial or full) repayment of financial support, i.e. the application of financial correction from civil law and public law aspect. However, this study only covers the Hungarian procedure in case of improper use of financial supports arising from the European Regional Development Fund, European Social Fund and Cohesion Fund.

In this topic only a few literature can be found in Hungary. Usually, monographs provide help to prepare an application to tender, while periodicals and publication of institutions of the EU deal with statistics, so examination of legal peculiarities of the system is generally ignored. Therefore, the author believes that the present study deals with an actual, current and relevant topic.

2. IRREGULARITY PROCEDURE

We can become acquainted with the legal background of irregularity procedures held/to be held regarding the financial period 2007-2013 from *Governmental Decree 4/2011. (I. 28.)* on the use of financial supports arising from the European Regional Development Fund, European Social Fund and Cohesion Fund in the financial period 2007-2013, from *Governmental Decree 55/2005. (III.26.)* on the recovery procedure of financial supports provided by the European Union and related state aids used unlawfully, improperly or not contractually and from *NFM direction 26/2012. (X. 24.)* on the unified operational handbook, and furthermore, on Union level primarily from the *Regulation EC 1083/2006*, *Regulation EC 2035/2005* and *Regulation EC 2168/2005*.

2.1. Definition of Irregularity

On one hand, 'irregularity' means 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 European Union by charging an unjustified item of expenditure to the general budget,¹ and on the other hand, any infringement of national law and any breach of obligation undertaken in the contract which jeopardize or would jeopardize the financial interests of Hungary.² The authority carrying out the procedure shall pay attention to the realization of elements of the above definition when it investigates unlawful, improper or not contractual use of financial support. The interpretation of breach of any provision of law or contract concluded in order to receive the financial support (hereinafter: grant agreement) is clear, however, for the first sight the prejudice of financial interests is difficult to interpret but can be explained as follows. According to *Regulation EC 1083/2006*, firstly Member States are entitled to financial supports arising from the Structural Funds, then, Member States divide it among the winners of several tenders in the framework of operational programs.

The use of money provided from the Structural Funds is evaluated by Member States and the managing authority shall also send an annual report to the European Commission on the execution of the operational programs. Thus, the number of irregularity procedures and their result has a significant

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¹ Regulation EC 1083/2006 Art. 2. Section 7.

² Governmental Decree 4/2011. (I. 28.) 2.§ (1) 24.



importance. Withdrawal and reduction of funds that is, when funds are not used in accordance with the original plans, infringe Hungary's interests because the Commission imposes sanctions on Hungary for the not proper execution of the financial support system and withdraws the money from the country. The reason beyond that sanction is that the aim of the Structural Funds is to solve the structural problems of certain regions and Member States while paying attention to the purpose of sustainable development. Furthermore, when Hungary or the EU cannot recover the improperly used financial support, expenses of a specific budget heading reduce and a certain amount of money will be unable to be used, it 'disappears'.

2.2. Irregularity Procedure

According to *Governmental Decree 4/2011. (I. 28.)*, an irregularity procedure can only be started after that the grant agreement is concluded with the beneficiary or the grant document (e.g. in case of alleviated consideration of a financial support) is issued. The procedure starts with the emergence of suspicion, which is recognized by the authority providing the financial support during a controlling, or the authority gets to know it from a third party. The procedure shall be finished within 45 days, which deadline can be extended once with another 45 days. During this period, so before passing a final decision, the legal entity carrying out the procedure has the opportunity to check the relevant documents and investigate the circumstances of the case, to hear persons and make on-site supervision.

The procedure can end with two types of decisions: one which establishes the irregularity and its legal consequences, and the other which determines that no irregularity was established. The law provides remedy opportunity for the beneficiary against the irregularity decision; the beneficiary is entitled to turn to the under-secretary leading the Prime Minister's Office.

According to Subsection (3) of Section 90, in case of establishment of an irregularity the following legal consequences can be applied alignment with the gravity of irregularity:

- i. reduction of eligible costs of the project and at the same time obligation of repayment of the unduly financial support,
- ii. cancellation of the grant agreement,
- iii. disqualification from the financial support system for a fix term but the maximum of 5 years, or
- iv. other legal consequence defined in EU law.

2.3. Financial Correction

Option a) and b) above means financial correction which can also be applied for a part of the support depending on the amount of money affected by the irregularity. However, the cancellation of the grant agreement, according to Subsection (1) of Section 320 of *Act IV of 1959 on the Civil Code* (the 'old' Civil Code), results in the termination of the contract with retroactive effect to the date of execution of the contract. The performed services, or in this case the money shall be refunded to the authority which provided it. According to Subsections (5)-(6) of Section 90 of *Governmental Decree 4/2011. (I. 28.)*, the financial correction shall be determined uniquely based on the documents of the case, and the amount of correction shall match the amount of money which incorrectly bothered the national budget and the Structural Funds. If the unique quantification of the rate of financial correction is not possible, it will be disproportionate to revoke all the money or it would give a misleading result, a flat-rate correction shall be applied. Flat-rate correction shall be based on the seriousness of the irregularity and the financial consequences of the irregularity.

With regards to the fact that the actual provision of financial support often takes place in more instalments, it can happen that the beneficiary does not receive all the instalments of the financial support (i.e. the total fund) before the irregularity decision is passed, in which case the withdrawn amount can be set-off in the amount that have not been paid out yet.

It is a great disadvantage for the beneficiaries that the repayable amount of money is subject to an interest equivalent to the basic rate of interest – in accordance with section 232 of the Civil Code –; while in case of delayed payment it is subject to a late payment interest. Furthermore, if penalty has been stipulated in the grant agreement, it can be also vindicated against the beneficiary. However, payment in instalments is an advantage. The execution of the decision on repayment, i.e. management of receivables includes a special element beyond the normally applied methods, receivables can be recovered as taxes and the national tax authority is obliged to carry out such procedures.

2.4. *Financial Correction Applied by the European Commission against the Beneficiary*

Not only a Hungarian legal entity is entitled to pass a decision on financial correction but also the European Commission, according to *Regulation EC 659/1999*. If a supposed unlawful financial support is brought to the attention of the Commission from any source, the Commission examines the information and starts the investigation promptly; the Commission gives opportunity for the Member State to make its remarks in the procedure. If at the end of the procedure a decision on repayment is made, the given Member State shall make the necessary actions to recover the money from the beneficiary. According to the judicial practice of the European Court, if a financial support was given by breach of law, the financial correction is always determined. The repayment is subject to late payment interest with regards to the fact that the fund was unlawfully used free of charge from the first time.³ Such case was carried out in 2008 regarding the fund provided to the waste water treatment plant of Csepel, Hungary. The Commission, in its final report, intended to determine a repayment of 10 billion HUF. The project was funded by the European Union in 65% and by the Hungarian State in 25%. The amount of money to be repaid was 25% of the fund. The reason behind the decision was that the Commission regarded it as serious irregularity that not the good type of public procurement procedure was started in the project. The controllers of the Union believed that it was a normal project but in the opinion of the Hungarian authority it was rather a complex project, thus, Hungary did not accept the argumentation of the Commission.⁴

2.5. *Prejudice of Financial Interest of Hungary*

At the definition of irregularity the author mentioned that irregularities may jeopardize the financial interest of Member States and the European Union. It is especially true when the beneficiary cannot completely meet its repayment obligation. It is reflected principally by two legal regulations.

On one hand, the European Commission may call the managing authority for repayment. In this case if the receivable is not recovered, the affected amount shall be transferred from the budget to the bank account of the managing authority in the given payment deadline,⁵ thus, Hungary will lose the money but the European Union will not.⁶

On the other hand, as it was already mentioned at the beginning of section 2 of this study that the European Commission may impose a sanction on a Member State for the non-appropriate execution of the support system. It is considered to be partial or full financial correction of the fund given from the Structural Funds to a Member State and imposed by the Commission upon the failure to meet the above obligation.⁷

3. EXAMINATION OF CIVIL LAW AND PUBLIC LAW ELEMENTS

In the relation when the legal entity provides the financial support and the beneficiary enters into a contractual legal relationship by concluding the grant agreement, the contractual parties according to the Civil Code, are equal. Section 2 of this study puts attention to the fact that in case of providing EU financial support, we cannot speak about a general civil law relationship because the law includes special provisions applicable to this relationship and on the side of the legal entity providing the financial support we can recognise authority powers, as well. I demonstrate this unique relationship from this aspect below.

³ Radnóczy Zsolt: *Támogatások az Európai Unióban* [Funds in the European Union]. Akadémiai Kiadó, Budapest, 2004, 226-228.

⁴ Eldugott szennyes [Hidden Laundry]. In: *HVG*, 2008. No. 47. (22 November 2008), 80.

⁵ Governmental Decree 4/2011. (I. 28.) 104.§ (3)

⁶ It was stated in connection with financial supports related to agricultural policy that the Member States often use a 'trick' in order to avoid the prejudice of their financial interests. When debts are deemed to be irrecoverable (if the beneficiary is insolvent or if the cost of the recovery action is likely to exceed the amount recovered), the regulation allows Member States to write them off. In such cases the debts are removed from the debtor accounts submitted to the Commission. If this write-off takes place before the four- and eight-year time limits, then the 50/50 rule does not apply and the amount is effectively charged in full to the EU budget. This creates the risk that debts are written off prematurely – that is before all possible recovery steps have been exhausted – in order to avoid the application of the 50/50 rule and the related charge on Member States. See in detail, *Recovery of Undue Payments Made under the Common Agricultural Policy*. European Court of Auditors Special Report, No. 8 (2011). Publications Office of the European Union, Luxembourg, 2011, 25.

⁷ Regulation EC 1083/2006, Art. 99.

Firstly, this study found it important to emphasise that not only an administrative-type body (e.g. managing authority) is entitled to conclude a grant agreement but also incorporated business associations (the so-called intermediate bodies) are allowed to do this by the authorization of law. In case of contracts concluded by intermediate bodies, it is remarkable that an intermediate body, mostly as a limited liability company or a public limited-liability company, owns such special rights which do not belong to any contractual party in a normal contractual relationship according to civil law.

The legal entity providing the financial support is entitled to carry out an irregularity procedure upon law authorization, so it is not the grant agreement which provides opportunity for the commencement of such procedure. However, both have close connections: the breach of the grant agreement, the improper use of the fund starts the irregularity procedure, while if an irregularity is established the legal entity providing the financial support is entitled to cancel the agreement or reduce the amount of the financial support. According to law, the legal entity providing the financial support carries out the irregularity procedure upon law, although the effective grant agreement is a prerequisite for that. Furthermore, even Subsection (1) of Section 92 of Governmental Decree 4/2011. (I. 28.) says that the irregularity decision determines, modifies and terminates rights and obligations arising from the contractual relationship of the beneficiary and the legal entity providing the financial support. In my opinion this specialty needs special attention. From the text of law we may conclude that the beneficiary must accept the unilateral irregularity decision and cannot use a remedy in front of a court or higher administrative body. There is only one remedy where the under-secretary leading the Prime Minister's Office has competence. It is very surprising for me because the under-secretary is neither a court, nor a higher administrative body and is dedicated to perform many different tasks. Thus, the legal entity providing the financial support has an exclusive, discretionary power to pass a decision on irregularity and this power cannot be taken away from the entity and judicial review is also excluded. Moreover, the irregularity decision can also come from Brussels, from the European Commission which institution is not a contractual party of the grant agreement (however, it is generally known that a part of the fund is provided by the European Union) and against its decision no remedy is ensured according to *Regulation EC 659/1999*; the beneficiary shall accept the decision and bear the legal consequences. Another peculiarity of this legal relationship is that if irregularity is established and the legal entity providing the financial support cancels the agreement, the national tax authority can recover the repayable amount as taxes charged with late payment interest. Section 301 of the Civil Code is applicable for late payment interest, which means that the interest is equivalent to the basic rate of interest despite the fact that in several cases two business associations are the contractual parties and according to section 301/A of the Civil Code, a higher interest could be counted. Of course, ignoring the latter provision is not unlawful, only less money will be recovered if the recovery is successful. Usually, the grant agreement defines the Civil Code as a law that prevails, however, the Civil Code and accordingly, the Code of Civil Procedure cannot be applied for all elements of the contractual relationship because in an irregularity procedure such provisions shall also be applied which are different from the regulations of the Civil Code.

Hungarian courts has already dealt with the applicability of the Civil Code, the cancellation of the grant agreement and the competence of civil court, the legal situation was not clear until the Supreme Court passed its economic decision of principle no. 2237/2010. I summarize the case behind the decision below because the author finds it important to get to know the different opinions of courts in this matter.

4. INSTEAD OF CONCLUSION – CASE STUDY

In the subject-matter the legal entity providing the financial support established in the irregularity procedure that the beneficiaries had committed irregularity and they shall repay the received fund. The legal entity also cancelled the agreement and the beneficiaries asked the court for judicial review of this cancellation. Later it was also a primary question in the case whether the civil court is competent in settling the legal dispute or not. The legal entity providing the financial support argued in the procedure at first instance that the grant agreement cannot exclusively be regarded as a contract based on the Civil Code because this legal entity had a competence transferred from the Community to carry out the irregularity procedure, which was acknowledged by the beneficiaries by signing the agreement. In contrast, at first instance the Metropolitan Court of Budapest stated⁸ that the Civil Code shall prevail at the

⁸ Court ruling of Metropolitan Court of Budapest [Fővárosi Bíróság] No. 22.G.41.644/2007/38.

interpretation of the parties' relationship and the civil court has competence to consider the legal dispute on the cancellation of the grant agreement. The Court referred to the fact that the right of cancellation was provided for the legal entity providing the financial support in accordance with law, and the Civil Code was stipulated in the agreement as a law applicable to the interpretation of the agreement. Anyway, the court established that the cancellation was lawful and rejected the beneficiaries' claim, who submitted an appeal against the decision.

The Metropolitan Court of Appeal (Fővárosi Ítéltábla) had a different point of view in the subject-matter⁹ and repealed the first instance ruling. The court at second instance believed that the legal entity providing the financial support concluded the grant agreement as an administrative body which is entitled to exercise official authority. Accordingly, public law shall prevail in the interpretation of the content of the contract, the rights and obligations of the parties. Thus, a public relationship existed between the beneficiaries (as clients) and the legal entity providing the financial support (as an authority) despite the fact that the Civil Code was stipulated in the agreement as a law that prevails. Moreover, the court emphasized that the beneficiaries shall repay the fund due to the irregularity decision, not as a consequence of cancellation of the agreement. Furthermore, the court ruling said that the civil court is not entitled to settle the dispute and there is only remedy against the irregularity decision.

The case continued at the Supreme Court as judicial review of the former court decision was requested. The Supreme Court stated in its ruling¹⁰ that the court of first instance was correct and the civil court has competence to settle the legal dispute between the parties based on the below reasons. Subsection (3) of Section 12 of *Act CXL of 2004 on the administrative authority procedure and general rules of services* (hereinafter: Ket.) lists that in the application of the act which administrative bodies shall be regarded as a body having authorization for settling authority matters. The legal entity providing the financial support is not mentioned in the list, in items a)–c). Although, Subsection (3) d) of Section 12 of Ket. says that any organisation, public body or entity which was not founded for performing administrative tasks is qualified as an administrative body if law authorizes it with authority power. Subsection (4) of Section 12 of Ket. includes that in such a situation all cases shall be defined where the provision of Ket. prevails. (These legal regulations are still in effect today.)

However, the court of second instance did not refer to any law according to which the legal entity providing financial support or its director should be regarded as an entity having authority power in making a decision on the cancellation, and did not refer to any law which stated that Ket. shall be applied. According to civil law, cancellation of a contract can be based on law or on a contract. The unilateral declaration on cancellation is a civil law declaration which was made by the legal entity providing the financial support upon the contract and not as an entity exercising authority power. None of the legal regulations stipulated that the legal entity providing financial support is entitled to cancel the contract in its authority power and no law said that Ket. is applicable for the review of this decision, the court established that the legality of the cancellation shall be examined in a civil law procedure and a civil court is entitled to run the case. The Supreme Court obliged the court of second instance to carry out a new procedure where the competence of civil court did not come up again.

⁹ Court ruling of Fővárosi Ítéltábla No. 9.Pf.21411/2009/3.

¹⁰ Court ruling of the Supreme Court [Legfelsőbb Bíróság, now Curia] No. Gfv.IX.30.1862010/7, which is also known as the economic decision of principle [gazdasági elvi határozat] No. 2237/2010.