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Application of the principle of proportionality:
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Introduction

Developments in the EU public procurement law have attributed a new level of significance to the principle of proportionality. While the public and utilities procurement directives of 2004¹ did not refer to proportionality as a general principle, the growing body of the CJEU case law has nevertheless developed and often relied on that principle in public procurement matters.² This has led to direct incorporation of proportionality among the other principles listed in the new, 2014 directives.³

In the case of Estonia, the Public Procurement Review Board,⁴ the body liable for review of public and utilities procurement cases in the first instance, has witnessed a somewhat surprising show of cases that challenge the terms of penalty clauses in public contracts and often focus on the principle of proportionality, either in combination of the principles of transparency or equal treatment or

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⁴ Vaidlustuskomisjon (hereinafter VaKo) – Riigihangete seadus [Act on Public Procurement], RT I 2007, 15, 76 … RT I, 23.03.2015, 24, § 119; Riigihangete vaidlustuskomisjoni põhimäärus [Statutes of the public procurement complaints’ commission], RTL 2007, 34, 599 … RT I, 08.05.2015, 9.
on its own. Based on the study of such review cases as well as a selected 100 uncontested public contracts, this article firstly aims to give recommendations for drafting penalty clauses in public contracts.

Secondly, the article outlines the interaction between the EU public procurement law and the national private law in situations such as potentially disproportional (unreasonable) penalty clauses that can simultaneously be challenged relying either on public procurement review options or private law remedies. The fact that private law remedies address and can be applied to the issues of drafting, interpreting or enforcing penalty clauses, has led to conflicting approaches with regard to the possible hierarchy or choice between such private and public law remedies.

1. Proportionality of penalty clauses

1.1 The Rationale for Establishing Proportionality

The general principles of EU public procurement law are explicitly specified in the new public procurement directives of the EU, and the Estonian draft for the new Public Procurement Act (hereinafter the PPA). Among the principles of competition, equal treatment, transparency and proportionality, namely the latter seems to have a relatively weighty influence on drafting the clauses of public contracts.

Even though neither the directives nor the PPA refer to any specific restrictions or guidelines for drafting public contracts, the freedom of contracting, incl. the freedom to generate substance of contract terms is nevertheless limited in the case of public procurement. In case of a doubt as to conformity of a particular term of a public contract with the public procurement law, the contract term...
can be challenged in the Public Procurement Review Board. This applies both when the interested party sees a breach of a particular detailed prescription of the law, or a conflict with a general principle such as the requirement of proportionality. For example, contractual penalty clauses are subject to the requirement of proportionality and can be challenged on the grounds of disproportionality.

The case law of the Court of Justice of the European Union has long recognised the importance of proportionality in procurement matters, applying the requirement of proportionality relatively broadly and making any step of procurement activity subject to proportionality between the action undertaken and the effect pursued. This seems to be a growing tendency in comparison to earlier years when other principles were attributed a more central meaning. In addition to application to procurement procedures, the principle of proportionality has acquired a significant role in interpreting and estimating legislative choices. Proportionality can be a valuable indication for a balanced interpretation of the procurement directives as well as a proper basis for evaluating harmony of a national legislation with the EU rules of public procurement.

Following the guidelines established in the CJEU case law as well as that of the Supreme Court of Estonia, the Review Board has interpreted the requirement of proportionality to mean that a requirement in the procurement procedure is

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10 VaKo decision in cases 112-12/133895, p 9 and 214-14/154639.


12 S. Arrowsmith 2014, p. 628; Evropaiki Dynamiki, case T-461/08, p 142; Antwerpse Bouwwerken, case T-195/08, p 57.

13 Arrowsmith 2014, p 628.


15 The Supreme Court of Estonia applies the same rationale for checking proportionality as does the CJEU. See, e.g. decisions in the administrative cases No 3-4-1-1-02 p 15, 3-4-1-3-04 p 31, 3-3-1-79-08 p 18 available at http://www.riigikohus.ee/ (Oct 10, 2016).
proportional if it is *appropriate* and *necessary*, i.e. *the least onerous* of the appropriate measures.\(^\text{16}\) A condition is *appropriate* if it facilitates achieving the intended purpose, and *necessary* when the same purpose cannot be achieved through some other measure that would be as effective but less burdensome.\(^\text{17}\) In addition, *moderation* has been referred to as a third component of proportionality, requiring that the intensity of any restriction must be in harmony with its intended purpose.\(^\text{18}\) Thus, in order to be proportional, any rules and restrictions applicable towards persons (bidders, applicants) partaking in public procurement must be relevant, necessary and moderate.\(^\text{19}\)

As any guidelines to proportionality of a clause or a decision mostly focus on the means or directions of reaching a proportionate choice as opposed to prescribing pre-established limits,\(^\text{20}\) deciding upon justified choices by contracting authorities will never be easy. Keeping that in mind, it is mostly required that contracting authorities be able to explain the rationale of making the choices and refrain from establishing contract terms arbitrarily, as will be shown below.

1.2 Proportionality and the contracting authority’s duty to justify choices

National administrative law as well as the general principle of transparency require that a contracting authority must always be able to justify its choices.\(^\text{21}\) In the cases of disputes challenging contractual penalty clauses, the contracting authority must be able justify the amount of the penalty. A failure to perform the obligation to justify could be observed, for instance, in a review procedure concerning the clauses of public contract published by the administration of the Rural Municipality of Pärsti on 7 May 2012 (award of a service concession for the collection and transportation of mixed non-industrial waste). The review procedure looked at the following contractual penalties provided by the draft of the concession contract:

- a failure to empty a waste collection container according to the schedule – 500 euros on the first occasion, 1000 euros on the second, 2000 euros on the third, and 2000 euros on every following occasion;

- a failure to reply to an e-mail of the waste holder within 24 hours – 100

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\(^{16}\) VaKo decision in cases No 50-10/123879, p 6; No 279-13/148288, p 7.8.


\(^{18}\) Arrowsmith 2014, p. 628; Antwerpse Bouwwerken p. 57;

\(^{19}\) VaKo decision in case 187-13/14490, p 20.1, 21.


\(^{21}\) E.g, the Supreme Court of Estonia decisions in administrative case No 3-3-1-62-08 p. 10.
Having established that the prospective turnover from performing the contract would have been only approx. 4500 euros a month, the Review Board considered the challenged contractual penalties to be unreasonably heavy. It was also found that the contracting authority had actually included the contractual penalties purely on a copy-paste method from the terms of a public contract of a similar subject matter, drafted by another municipality in another public procurement. However, the contracting authority failed to demonstrate any other significant similarities between the two procurements, besides the subject matter, e.g. as to the contractual volume. Concluding that the contracting authority failed to explain the proportionality of the contractual penalties, the Review Board was unable to ascertain the proportionality of the contractual penalties and therefore ordered the Contracting Authority to bring the penalty clauses of the contract into compliance with the PPA.22

A similar conclusion was made with regard to another contractual penalty clause: an 8000 euro penalty accompanying the right of prompt termination of the contract in case of any, possibly minor failure on the part of the contractor. Again, the Review Board was unable to estimate the proportionality of the penalty due to contracting authority’s failure to clarify when exactly the penalty would be applicable.23 In both cases, the reason for granting the request for review was clearly the contracting authority’s inability to explain the considerations that served as the basis for choosing the penalties in the exact amount and terms. When in the latter case, the penalty clause was obviously non-transparent as well as possibly disproportionate, the primary reason for deciding the case in the favor of the claimant relied in the contracting authority’s making arbitrary decisions as opposed to reasonable considerations.24

Naturally, it is not advocated that every contracting authority started drafting public contracts from a blank sheet. On the contrary, following examples of analogous contracts with similar terms, or use of standard term contracts should doubtless be regarded as a usual and justified practice, especially when the contracts are of similar substance, volume and estimated price, and the nature of the obligations is equivalent. However, blind copying of contracts with no regard to their material terms must be avoided – instead, a contracting authority should approach any model critically, acknowledging and being able to give reasons for its choices. To ensure that the contracting authority uses its discretion lawfully,

22 VaKo decision in case 112-12/133895, p. 9.1.
23 VaKo decision in case 187-13/14490, p 21.
24 The same conclusion was reached in VaKo decision in case 54-15/160792, p 9.
the contracting authority’s decision must be reasoned and verifiable. In addition to allowing transparency and the possibility to conduct outer administrative review, such behaviour facilitates internal review by the contracting authority itself and allows better certainty of making a right choice.\(^25\) Thus, a proper reference to, for instance the aim of the penalties, relevant trade practices, any special circumstances related to the concerned obligations, etc. can justify proportionality of the above mentioned contractual penalties.

Indiscriminate sanctioning of all, including minor breaches with similar consequences, can cause a finding of disproportionality, as was established in a review case concerning a waste transport procurement by the Rural Municipality of Põlva. The public contract advertised by the contracting authority established an equal contractual penalty (1000 euros) for any breach registered in the course of performing the public contract. In the Review Board’s opinion, when contractual obligations are “not comparable in terms of possible consequences”, their equivalent sanctioning is “clearly disproportionate.”\(^26\) Not unlike the above example, the rationale of the following penalties can be questioned: penalty in the amount of ca 18\% of the total contract price for any occasion of selling fuel of lower than agreed quality;\(^27\) a penalty of ca 26\% of the total contract price for any breach of confidentiality under a software contract,\(^28\) ca 27,5 \% of the total contract price for any breach in a contract for purchasing a children’s playground equipment.\(^29\) By establishing the exact same contractual penalty for radically different breaches of a public contract, the contracting authority can, in the opinion of the Review Board, violate the general principles of public procurement. Particularly when the intensity and seriousness of violations covered by the same penalty clause can range from a minor to a significant breach as in the above examples, a differentiated penalty should be preferred.

Upon assessing the proportionality of a contractual penalty, it may be of help to recognize the function of the particular penalty, or the purpose at which it is aimed. Generally, the contract law vests two main functions of contractual penalties: firstly, the actual fulfilling of performance obligations and prevention of breaches of the contract, and secondly that of compensation for damage. As a legal remedy, the latter type of penalty is set to to ensure that in case of a breach, the creditor is able to easily demand payment of at least the minimum compensation that was agreed as a contractual penalty. As a third option, a contractual

\(^{25}\) The Supreme Court of Estonia in administrative cases No 3-3-1-54-03, p 36, No 3-3-1-49-08, available at http://www.riigikohus.ee/ (April 10, 2016)

\(^{26}\) VaKo decision in case No 214-14/154639.

\(^{27}\) Procurement Reference No 158273 by AS Saarte Liinid. Procurement documents published in the course of this and other award procedures are accessible at the national public procurement register at https://riigihanked.riik.ee/register/HankedOtsing.html (October 10, 2016)

\(^{28}\) Procurement Reference No 148768 by Eesti E-Tervise SA.

\(^{29}\) Procurement Reference No 159796 by SA Tallinna Kultuurikatel.
penalty can function as a withdrawal money (repentance fee), giving the debtor, provided that the agreed sum is paid, the right to withdraw from the contract in a situation where there is no other legal basis for termination, e.g. when no fundamental breach has been committed by the other party. Of course, a penalty can combine any of these functions (purposes).

Of course, these purposes can also suggest a minimum level for proportional contractual penalties. A penalty clause of a public contract should be sufficient to relieve the actual financial harm caused by a possible failure to deliver and the need for substitute performance, particularly in cases where continuous or timely provision of service or use of supplies is critical. Otherwise, the penalty can induce the tenderer to breach the contract instead of making (costly) efforts at proper performance. For obvious reasons, there is no case law complaining of too low contractual penalties, however, some of the published contracts raise doubts as to adequacy of the penalties provided there. An example: a public contract published by the Northern Estonian Regional Hospital Foundation for the purchase of a device for preliminary processing of full blood and bone marrow samples referred to the contracting authority’s right to “charge a contractual penalty of 100 euros […] in the event of detecting performance of substandard quality”, and “in the event of other breaches […] up to one hundred (100) euros per breach.” The price of the concerned contract being 54,765 euros, a contractual penalty of 100 euros constituting 0.18% of the contract price probably might not express any significant pressure upon the contracting party to perform the contract properly or secure any actual compensation for damages to the contracting authority.30 Contractual penalties of at least a minimum reasonable amount can be important for enforcing good administrative practices and reducing corruption in public procurement, unproportionally low contractual penalties should therefore be discouraged.

2. Alternative review options

2.1 Private law remedies concerning penalty clauses

In many Member States, incl. Estonia, public procurement contracts are regarded as private law contracts, being subject to both national private law and the general principles developed in European Union law.31 Correspondingly, the usual rights and liabilities of contract law apply to the public contracts as well.32 Speaking of

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30 Procurement Reference No. 155813 by SA PERH.
31 Simovart 2010, lk 9–10, 32, 176-177.
32 On simultaneous application of both private and public laws to public contracts see the judgements of the Supreme Court of Estonia in the administrative cases No 3-3-1-8-01 para 13-14, 3-3-1-15-01 para 11–12.
penalty clauses, the law offers various options for contesting or otherwise legally influencing an unreasonably heavy contractual penalty. These options can be applied to public contracts as well.

Firstly, § 162 of the Law of Obligations’ Act (LOA)\(^{33}\) allows a debtor to request that the court reduced an unreasonably heavy contractual penalty to a reasonable amount. Upon deciding over such a matter, the court takes into account, above all, the history of performance of the contract and indicators characterising the debtor: the extent of performance of the obligation by them, the legitimate interest of the other party as well as the economic situation of both parties. However, this right is available only when a breach of contract has already been committed and the penalty fallen due but has not been paid yet (subsection 3 of § 162 of the LOA). It is not possible to pre-emptively demand the alteration of the amount of a penalty via judicial transformation of the penalty clause. The amount of the contractual penalty is also never evaluated abstractively, but by taking account the specific circumstances related to the performance of the particular obligation. Due to the case-by-case approach, a mere comparison of, for instance, a comparison with ordinary penalty amounts in the same types of contracts is not sufficient for identifying an unreasonably heavy contractual penalty. Instead, the presence of the particular circumstances set out in subsection 1 of § 162 of the LOA needs to be established.

Secondly, in a standard terms’ contract, any clause that provides for an unreasonably heavy contractual penalty for the benefit of the party who prepared the contract, may prove to be void under subsection 1 and clause 5 of subsection 3 of § 42 and § 44 of the LOA. Most public contracts are made on standard terms, always so when when awarded as a result of an open or restricted procedure.\(^{34}\) Thus, a penalty clause in a standard term public contract can be declared void if it is unreasonably harmful for the party of the contractor (supplier).

However, neither of the aforementioned options applies preventively before the award of the contract. Instead, application is possible no sooner than at the moment of awarding the public contract (in the case of voidness based on subsection 1 and clause 5 of subsection 3 of § 42 of the LOA), or after an actual claim for the contractual penalty has been presented by the contracting authority (under § 162 of the LOA). Thus, even though private law instruments provide remedies applicable in cases of unreasonableness of contractual penalties, these do not work towards legal clarity or otherwise influence the situation of competition before the contract award. The requirement of equal treatment of tenderers and transparency of competition however make it necessary to find a solution in the contract award stage already.

\(^{33}\) Võlaõigusseadus, RT I 2001, 81, 487 … RT I, 11.03.2016, 2

\(^{34}\) Simovart 2010, lk 50, 181.
2.2 Purpose of private and public procurement remedies

These two review systems – private law and public procurement law remedies – have different purposes. While contract law remedies are directed at finding a justified resolve to issues arising within contractual relations between the two contracting parties, the EU public procurement law is primarily aimed against obstacles to open competition. With regard to such different aims, a penalty clause that is considered disproportionate (unreasonable) for the purpose of one type of remedy, may not necessarily be regarded as disproportionate (unreasonable) for the purpose of the other. Disproportionate terms of procurement can become obstacles that may prevent some bidders from joining the competition or others from winning the award and as such, need to be reviewable despite of them potentially (not) being regarded unreasonable in the meaning of private law.

The remedies directives carry the purpose of establishing effective and rapid review procedures in support of the substantive EU procurement law, protecting both the EU procurement policy in general (opening up of competition in the public procurement market) as well as the individual aggrieved tenderers in particular. The need for a speedy and efficient review justifies not postponing the resolving of a contractual issue until the contract performance stage as well.

Keeping in mind the above, a review board or court should not refuse to review public contract clauses for the mere reason of private law remedies becoming available, should the same issue later arise in the course of performing the contract. Naturally, this does not change the competence of the Review Board that is still authorized to review the possible violation from the standpoint of the public procurement law only, and not to judge over or give a preliminary assessment about any possible conflict in the light of the private law. For instance, while interpreting a public contract might be an answer to confusion emerging in the course of performing the public contract, the Review Board cannot issue a ruling

37 Case No C-570/08, Simvoulio Apokhetefseon Lefkosias v Anatheoritiki Arkhi Prosforon para 29–30 and Case No C-337/06 Bayerischer Rundfunk and Others paras 38 and 39; Article 1 paragraph 1 of the Directive 89/665/EEC.
38 The fourth recital of the Directive 89/665/EEC.
39 Such was the opinion of the Tartu Administrative Court in case No 214-14/154639 - https://www.riigiteataja.ee/kohtulahendid/detailid.html?id=151338986 (Oct 10, 2016) that referred to the contractor’s right to later challenge the possibly unreasonable amount of disputed penalty in a public contract under th LOA § 162.
interpreting the draft public contract before its award (during the procurement procedure). On the other hand, the possibility of resolving a controversy based on private law rules does not dismiss the fact that publishing unclear or ambiguous public contract terms can violate the requirement of the transparency of public procurement, and significantly disproportionate contract terms can discourage competition. Should the Review Board establish that a contract term is so confusing as to breach the obligation of transparency, or so disproportionate that it must be redrafted, it is entitled to order the contracting authority to do so and not leave the dispute subject to any possible civil matters that may or may not be invoked later.

Even though national review systems are different, the general conclusion applicable to all must be that no potentially available private law remedies can exclude access to review on the grounds of a possible violation of public procurement law.

Conclusions

The principle of proportionality, particularly together with the requirements of transparency and equal treatment sets certain limits to drafting the contract clauses. As an example, penalty clauses in public contracts must be appropriate, necessary and reasonable with regard to the function(s) (purposes) that the particular penalty serves. In case of a doubt, the clauses can be challenged in the Public Procurement Review Board. The mere fact that a dispute over or a lack of clarity of a contract term can be successfully resolved using private law remedies does not erase a violation of the general principles of public procurement law. The presence of any alternative review option, incl. possible availability of contract law remedies in the future, cannot warrant the refusal to apply public procurement remedies in the contract award period. Otherwise, the purpose of the remedies system is not fulfilled, leaving the bidders without a rapid and effective review option and possibly restricting competition for the particular public contract.