The surety bond in the new Bidding Law and the problems of adverse selection and moral hazard*

O seguro-garantia na nova Lei de Licitação e os problemas de seleção adversa e risco moral

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ABSTRACT

The paper aims to discuss the performance bond institute applicable to administrative contracts of works and services, considering the peculiarities involving this insurance model in view of the trilateral relationship between the Public Administration, the bidder and the insurer. This is a bibliographical research study, and method applied was hypothetical-deductive, identifying the problems in the context of public works and then seeking solutions through the use of performance bond. Thus, it is intended to examine how the performance bond can contribute

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to the mitigation of information asymmetry and provide the necessary incentives for the execution of the contract.

KEYWORDS

bids — performance bond — information asymmetry — adverse selection — moral hazard

RESUMO

O artigo tem como objetivo debater o instituto do seguro-garantia aplicável aos contratos administrativos de obras e serviços de grande vulto, considerando as peculiaridades que envolvem este modelo de seguro diante da relação trilateral entre a administração pública, o contratado e a seguradora. Trata-se de uma pesquisa bibliográfica, e o método aplicado foi hipotético-dedutivo, partindo da identificação de problemas no cenário das obras públicas para, em seguida, buscar soluções por meio da utilização do seguro-garantia. Desse modo, pretende-se examinar como o seguro-garantia pode contribuir na mitigação da assimetria de informações e fornecer os incentivos necessários para a execução do contrato.

PALAVRAS-CHAVE

licitações — seguro-garantia — assimetria de informação — seleção adversa — risco moral

1. The performance bond and its normative provision within the scope of public administration

A major challenge for public administration is the extensive number of contracts for unfinished works that exist in the country. Sometimes administrative contracts for the execution of public works are signed and begun, and, in the short or medium term, their execution is interrupted, causing stoppages and endless lawsuits.

The special audit carried out by the Federal Audit Court, in 2018, after analyzing more than 30 thousand public works financed with federal public money, found that about 37% of these works were paralyzed or unfinished. The main causes identified by the special audit were contracting based on a

deficient initial project; insufficiency of financial resources from the state or municipality co-responsible for the works; and the difficulty of subnational entities in the management of federal resources.[1]

These works represent an estimated investment of R$ 144 billion, of which R$ 10 billion has already been invested in stalled works not adding any benefit to society, delaying the supply of public services and economic growth.

Regarding the adverse consequences of unfinished works and the need to ensure compliance with contracts, this article will analyze, in particular, one of the legal hypotheses of guarantee modalities, the insurance guarantee, applicable to administrative contracts agreed by the government to carry out works, services and supplies.

The performance bond is an important instrument in guaranteeing the execution of contractual obligations, employed by the policyholder in relation to the insured. The insurer, a third party in relation to the contract entered into, is guarantor of the fulfilment of the contractual obligation. Note, therefore, that the performance bond contract is distinct compared to a typical insurance contract, given the presence of three parties involved.

The technical regulation of the performance bond is contained in Circular No. 477/2013, of *Superintendência de Seguros Privados* (Susep). Among the normative provisions contained in the Circular are arts. 4 and 5:

> Art. 4 defines the Performance Bond: Insured — Public Sector, insurance which aims to guarantee the faithful fulfilment of the obligations assumed by the policyholder towards the insured, owing to participation in a bidding process, in a master contract pertaining to works, services, including advertising, purchases, concessions or permissions within the scope of the Powers of the Union, States, the Federal District and the Municipalities, including, even:
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> I — administrative processes;
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> II — legal proceedings, including tax foreclosures;
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> III — administrative instalments of tax credits, registered or not in active debt;
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> IV — administrative regulations.

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[1] BRASIL. Tribunal de Contas da União. *Acórdão 1079/2019*. Plenário. Relator: ministro Vital do Rêgo. Sessão de 15/5/2019. Available at: https://pesquisa.apps.tcu.gov.br/#/resultado/acordao-completo/1079%252F2019/%2520/%2520?ts=1625856845973. Accessed: 26 May 2021.

> Single paragraph. Also guaranteed by this insurance are the amounts owed to the insured, such as fines and indemnities, arising from default of the obligations assumed by the borrower, provided for by specific legislation in each case.
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> Art. 5 Performance Bond is defined: Insured — Private Sector, insurance which aims to guarantee the faithful fulfilment of the obligations assumed by the policyholder for the insured in the main contract signed in a different ambit from that mentioned in art. 4.[2]

In the legal scope applicable to public administration, considered as a starting point vis–a-vis Law 8.666/1993, it is important to note that the modality of the performance bond was not included in the list of instruments furnished to guarantee public contracts, according to the original forecast of art. 56. It was through Law No. 8.883/1994 that the insurance modality became subject of choice alongside the cash collateral modalities or public debt and bank guarantees.

Law no. 8.666/1993, in art. 56, § 2, determines that the modalities of guarantees must, as a rule, be limited, not exceeding 5% of the Contract value. Exceptionally, when the public administration is responsible for works, services and supplies of great magnitude, that involve high technical complexity and considerable financial risks, § 3 prescribes that the guarantee limit can be raised to up to 10% of the contract value.

The recent *Lei de Licitações e Contratos Administrativos*, Law no. 14.133/2021, assigned new parameters to the maximum coverage percentages in relation to major works and services, strengthening the use of the performance bond. Art. 97 of the new law provides for the legal definition of the instrument, but also establishes rules to be observed in hiring involving this type of guarantee:

> Art. 97. The Performance Bond aims to guarantee the faithful fulfilment of the obligations assumed by the contractor on behalf of the Administration, including fines, damages and indemnities arising, observing the following rules in contracts governed by this Law:

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[2] SUPERINTENDÊNCIA DE SEGUROS PRIVADOS. *Circular nº 477*, de 30 de setembro de 2013. Dispõe sobre o Seguro Garantia, divulga Condições Padronizadas e dá outras providências. Available at: http://www2.susep.gov.br/bibliotecaweb/docOriginal.aspx. Accessed on: 31 May 2021.

> I — the term of validity of the policy will be equal to or greater than the term established in the main contract and must accompany changes with regard to validity by issuing the respective endorsement by the insurer;
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> II — the Performance Bond will remain in force even if the contracted party has not paid the premium on the agreed dates.
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> Single paragraph. In contracts of continued performance or continuous supply of goods and services, substitution of the guarantee insurance policy will be permitted on the renewal or anniversary date, provided the same conditions and coverage are maintained in force and provided that no other period holds, except for that provided for in § 2 of art. 96 of this Law.

As a general precept, art. 98 establishes that the guarantee may be of up to 5% of the initial value of the contract, allowing for an increase of this percentage of up to 10%, provided that it is duly justified through analysis of technical complexity and the risks involved.

Note the fact that Law no. 14.133/2021, unlike the old law, did not condition, at that time, application of the increase of up to 10% to the requirements of a major work. The legislator dedicated a specific article to large scale engineering works and services.[3] Art. 99 includes, in particular, among the types of insurance provided for by law, only the performance bond, with a revision clause, increasing the percentage required to up to 30% of the initial value of the contract.

Art 102 of the new bidding law was designed to regulate the insurance-guarantee modality for the hiring of engineering works and services. The provision establishes that bidding process notification may require that the guarantee be in the form of a performance bond, as well as requiring the obligation of the insurer to assume the execution and fulfil the agreed object in case of default of the contracted bidder.[4]

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[3] Art. 6, item XXII, of Law No. 14.133/2021, defines works, services and supplies of a large quantity as those whose estimated value exceeds BRL 200,000,000.00 (two hundred million reais).

[4] Law 14.133/2021 — Art. 102. When contracting engineering works and services, the tender notice may require provision of guarantee in the form of insurance and provide for the obligation of the insurer, in case of default by the contracted party, to assume the execution and complete the object of the contract, in which case:

Item I of art. 102 prescribes that the insurer must participate in the contract and also contractual amendments, as an intervening consenting party, i.e., express its acquiescence to the provisions of the contract. Hence the importance of the insurer knowing, in detail, the clauses of contractual arrangements, so that the obligations and rights of each party are clear in requiring the borrower to carry out the work in accordance with the predicted qualitative and quantitative parameters.[5]

With regard to the prerogatives of the insurance company, it may accompany monitoring of the performance of the contract and will have free access to the premises where the contract is executed and the technical audit documents and accounting, and may require clarification from the technician responsible for the work.

Art. 102 of Law no. 14.133/2021, also allows the insurer the possibility of subcontracting the completion of the contract, in whole or in part, including, the issue of a commitment in its own name, or of whom it indicates to fulfil the contractual obligations, in accordance with tax compliance.

It is interesting to note that the insurance company, although not a participant in the bidding process, will become responsible for completion, on its own or by subcontracting, resulting in an indirect subrogation of the administrative contract under the agreed conditions by the government and the contractor. Not opting for the completion of the work, the insurer shall fully bear the amount provided for in the policy of the performance bond.

Certainly, there will be a cost-benefit analysis on the part of the insurer comparing the possibility of taking over the execution of the work and paying

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I — the insurer shall sign the contract, including the amendments, as an intervening consenting party and can:
a) have free access to the premises where the main contract is undertaken;
b) monitor the execution of the main contract;
c) have access to technical and accounting audits;
d) request clarification from the technician responsible for the work or supply;
II — the issuance of a pledge on behalf of the insurer, or to whom it indicates for the conclusion of the contract, will be authorized provided that its fiscal regularity is demonstrated;
III — the insurer may subcontract the conclusion of the contract, in whole or in part. Sole paragraph. In the event of default by the contractor, the following will be observed:
I — if the insurer executes and concludes the object of the contract, they will be exempt from the obligation to pay the insured amount indicated in the policy;
II — if the insurer does not undertake the performance of the contract, it will pay the entirety of the insured amount indicated in the policy.

[5] Paragraph 3 of art. 96 of Law No. 14,133/2021 prescribes that the tender notice shall set a minimum period of 1 month, counted from the date of approval and prior to the signing of the contract, for the provision of the guarantee by the contracted party when opting for the guarantee insurance modality.

the limit of 30% of the initial value of the contract. Various incentives and costs are involved, but, within the scope of public contracts, we may question whether the payment of the policy would be enough for the public authority to adopt other means for the completion of a major enterprise. Undeniably, insurers will seek the lowest cost to relieve themselves of their contractual obligations, often fulfilled by paying the policy indemnity.

We may question the real possibility of the insurer exercising, on their own account, activity related to construction, engineering, etc., given the limitations contained in the social contract and regulatory norms of the insurance market, which determine a single corporate purpose linked to insurance activity.[6]

Likewise, another important issue about 14.133/2021 which, in art. 97, II, establishes mandatory contract compliance rules for performance bond contracts within the scope of the public administration. The instrument prompts debate about the maintenance of the validity of the performance bond when the contracted party fails to pay the premium on the agreed dates.[7]

It is clear that the policyholder is responsible for paying the premium to the insurer within the terms established in the contract. However, law of tender determines that the insurance will continue in force even if the policyholder does not make the payment of the premium within the stipulated deadlines, unlike in most traditional insurance contracts.

For this reason, with respect to the purpose of the premium in performance bond contracts, it is important to note that the premium is covered differently in relation to the commercial practice adopted in traditional insurance.

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[6] SOGAYAR, Alberto; MATOS, Tácito Ribeiro de; ALCANTARA, Ana Beatriz Quintas Santiago de; GUIMARÃES, Fernando. *A cláusula de retomada na nova Lei de Licitações,* 2021. Available at: https://www.agenciainfra.com/blog/infradebate-a-clausula-de-retomada-na-nova-lei-delicitacoes/. Accessed: 4 Jun. 2021.

[7] Law 14.133/2021 — Art. 97. The guarantee insurance aims to guarantee the faithful fulfilment of the obligations assumed by the contractor in relation to the Administration, including fines, losses and indemnities arising from default, subject to the following rules in contracts governed by this Law:

I — the term of validity of the policy will be equal to or greater than the term established in the main contract and must accompany the changes regarding its validity by issuing the respective endorsement by the insurer;

II — the guarantee insurance will continue in force even if the contracted party has not paid the premium on the agreed dates.

Sole paragraph. In contracts of continued performance or continuous supply of goods and services, the replacement of the guarantee insurance policy will be allowed on the renewal date or anniversary, provided that the same conditions and coverage of the current policy are maintained and that no period applies, except for the provisions of § 2 of art. 96 of this Law.

While in traditional insurance the premium contributes to the formation of a financial resource fund to allow the payment of any indemnities expected for the risks contained in the policy, in the contractual performance bond model, the premium has a different nature, as it not based on the average probability of the occurrence of the claim.[8]

As stated by David Raick, the losses in performance bond contracts must be compensated by means of a counter-guarantee agreement. Hence, with regard to the risks covered by the performance bond contract, no losses are expected by occurrence of a claim, as it is counter-guaranteed by the policyholder.[9]

Faced with these scenarios, it is clear that the characteristics and circumstances in which the performance bond is agreed upon make it even more complex. The trilateral relationship between the public administration, the contracted and the insurer is inserted in a broad context of asymmetry of information that is intrinsically related to the completion of contracts of this nature.

2. Brief overview of the performance bond instrument in American law

For a better understanding of the challenges of performance bonds in the Brazilian legal system, it is important to analyze, albeit concisely, the characteristics of the North American performance bond model, as it is possible to identify some similarities with and differences from the practices adopted in Brazil, aiding reflection on the hiring of public services and performance bond coverage.

The enactment of the Heard Act, in 1894, established a performance bond obligation in all contracts entered into by the US administration, transferring to the private sector the risks arising from default on the execution of contracted works.

As is well highlighted by Pedro Henrique Christofaro Lopes, the use of the performance bonds was initially intended as a protection of contractor employees and suppliers more than to guarantee the interests of the State.

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[8] RAICK, David. *O uso de fidejussão como garantia do adimplemento das obrigações em contratos de obra pública*: um estudo em prol da aplicação do modelo estadunidense de performance bonds ao contexto brasileiro. Monografia (bacharelado) — Faculdade de Direito, Universidade de Brasília, Brasília, 2018. p. 35.

[9] Ibid., p. 36.

Before the drafting of the law, the North American civil construction market was in an unstable condition, with no specific requirements for technical qualification. The default rate was high and it was common for contracted companies to have large debts even before the works were started. In this context of uncertainty, the Heard Act was passed.[10]

A few years later, specifically, in 1935, the Federal Miller Act provided for greater protection, with coverage of 100% of the contract at the federal level, and the use of guarantees for suppliers and hired labour. This measure was intended to prevent the judicial processing of the public administration where the contractors were in default to third parties.

It is in the Federal Miller Act that several guarantees in hiring public were foreseen, such as the competition guarantees (*bid bonds*), of *performance bonds* and payment of obligations for labour, suppliers and subcontractors (*labour and material bond*).[11]

The bid bond is a performance bond that provides the administration with a means to recoup some of the cost of having to repeat the bidding process, in the event that the winner of the tender does not agree to enter into the contract or fails to provide the required guarantees. In turn, the performance bond provides a guarantee of execution of the contract in cases of default. The labour and material bond, also called payment bond, ensures that certain contractors and material suppliers be indemnified in cases where the agent does not make the payments.[12]

Note that, in the US, almost all 50 states, as well as the District of Columbia and most legal jurisdictions, have enacted laws similar to the Federal Miller Act, requiring performance bonds on public works above certain values.

It is important to mention research carried out by Francisco Galiza, in 2015, which measures data related to performance bond obligations in the US states. The author demonstrates the hypotheses and contractual standards vis-a-vis the performance bonds in each state and the percentage of insurance coverage in relation to the contract value.[13]

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[10] LOPES, Pedro Henrique Christofaro. *Análise econômica do direito e contratações públicas: o Performance Bond em contratos de obras públicas como instrumento para mitigar a assimetria de informações*. Dissertação (mestrado) — Escola de Direito do Rio de Janeiro, Fundação Getulio Vargas, Rio de Janeiro, 2019. p. 98.

[11] GALIZA, Francisco. *Uma análise comparativa do seguro garantia de obras públicas*. Rio de Janeiro: ENS-CPES, 2015. p. 15.

[12] Ibid., p. 28.

[13] Ibid., p. 31.

The states of Arizona, Arkansas, California, Colorado and Connecticut establish coverage by performance bond at the level of 100% of the value of the work, which is required only for works budgeted at a minimum value, ranging from US$20,000 to US$100,000. The states of Delaware, Florida, Georgia, Hawaii, Indiana, Minnesota, Mississippi, New Jersey, Texas, Utah, among others, also require 100% coverage, without stipulating a minimum value.

In turn, the states of Nevada, Maryland, Alabama, Rhode Island and the District of Columbia prescribe that insurance coverage must cover at least 50% of the value of the work. Note that the states of Massachusetts, Tennessee, Puerto Rico and Wyoming determine, at least, that the insurance coverage must be 25% of the contractual value.[14]

Thus, when examining the scope of the performance bond instrument, the USA demonstrates a wide acceptance in public contracts, even though there is a difference of percentages in relation to insurance coverage and the value, which can vary between 25% and 100%.

The procedure adopted in the US for performance bond contracts resembles the Brazil scenario in certain aspects, mainly in the consequences arising from the declaration of the claim, where it is up to the insurer to carry out one of the following measures: 1) finance the policyholder, with the beneficiary's consent, so that he can conclude the contract; 2) waive the right to conclude the performance of the contract, provided selection in the market interested in executing the contractual object; 3) execute the contract after investigation of the claim, limited to the amount in which it was liable to the insured; 4) deny liability, in whole or in part, communicating to the insured the relevant reasons.[15]

Yet, as evidenced by Vitor Boaventura Xavier, American insurance companies may opt for reinsurance operations, with the aim of passing on a percentage of its risk to the reinsurer for the issuance of new policies. The author points out that US legislation not only permits reinsurance operations, besides allowing insurers to constitute co-suretyship agreements, i.e., agreements for issuing joint venture policies when the policyholders have different insurers or when the policyholder cannot have the policy underwritten. Hence the co-suretyship agreements are responsible for defining the obligations of the

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[14] Francisco Galiza, Uma análise comparativa do seguro garantia de obras públicas, op. cit., p. 33.

[15] XAVIER, Vitor Boaventura. *O seguro garantia de execução do contrato — Performance Bond*: uma análise dos aspectos regulatórios e concorrenciais da sua exigência pela administração pública no Brasil. Monografia (bacharelado) — Faculdade de Direito, Universidade de Brasília, Brasília, 2017. p. 31.

associated insurers and for distributing the risks assumed by each in the contractual relationship.[16]

Comparatively, the Brazilian legal system, through Law 14.133/2021, made forward steps in relation to the percentage of coverage of performance bond contracts, until then regulated by Law No. 8,666/1993, increasing from 10% to 30% for major engineering works.

On the other hand, it appears that only a few US states established such a small range of coverage, along the lines of Brazil, as many require minimum coverage of 50% or even 100% to guarantee the execution of the work. The American experience suggests important contours on how the performance bond instrument can provide more efficiency, increasing the participation of insurance companies in the inspection process and making them responsible for the resumption of the contract in case of default.[17]

3. Adverse selection and moral hazard in public contracts and the role of the performance bond

The classic conception of contracts assumes the idea of reasonableness and rationality, where all the wills of the parties are predictable and are parameters for decision-making among those involved. However, the completion of contracts causes great concern, arising from the information asymmetry between the parties involved.

The scenario of extensive knowledge and full understanding of information in closing contracts does not occur in the real world. The bounded rationality of economic agents, the complexity and uncertainties, as well as the opportunism of different parties, are factors that result in the imperfect completion of contracts, even more so with major works in the scope of contracts carried out by the public administration.

Alexandre de Ávila Gomide and Ana Karine Pereira point out that, the more actors are involved and ambiguous the conditions are for decision making, the more problematic the use of rational planning techniques and

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16 Ibid., p. 32.

17 PASCHOA, André Paulani; ROCHA, Silvio Luís Ferreira da. Contrato de seguro-garantia e seus efeitos na execução de obras públicas — notas sobre o projeto de lei de licitações. *Revista da AGU*, Brasília, v. 19, n. 3, p. 39, jul./set. 2020.

selection of projects becomes.[18] The public administration is not in a position to analyse all the necessary requirements to divine the winning bidder's intentions, so the new bidding law, as well as the rules that preceded, tries to indicate a better approach, adopting criteria that reveal more information about participants in the bidding process.

Law no. 14.133/2021, art. 80, establishes pre-qualification as a technical-administrative procedure in the selection of interested parties for future bids, whereby documents will be presented showing technical and economic capability. Sometimes, these criteria are insufficient to demonstrate the real credentials of the bidder for the execution of the contract.

It is well-known that public contracts are plagued by the "spreadsheet game" — assigning unit prices below market value for services and, after a period, claiming of an unforeseen event or force majeure, thus requiring a revision of the contract based on an economic-financial balance.

Opportunistic practices can also occur when higher prices are set for services that may be executed earlier. As the company has greater market expertise than the government, privileged information means certain services may entail alterations in values during the execution of the work for technical reasons.

Ronaldo Fiani points out that opportunistic conduct occurs frequently in contracts for major infrastructure works, as the specific assets involved in these contractual arrangements cannot be adapted for other purposes without increasing costs.[19] When the cost of transferring an asset to another location is restricted, when an asset is designated for a specific purpose or when the value of an asset is linked to the promise of future income from the service provided, there is greater risk of opportunistic action, causing the problem known as hold up. That is to say: one of the parties becomes hostage to the threats of other agents, given that the withdrawal of its specific assets could cause a significant devaluation, allowing contractual changes to be made under conditions different from those agreed at the beginning of the transaction.[20]

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[18] GOMIDE, Alexandre de Ávila; PEREIRA, Ana Karine (Ed.). *Governança da política de infraestrutura: condicionantes institucionais ao investimento*. Rio de Janeiro: Ipea, 2018. p. 13.

[19] FIANI, Ronaldo. Arranjos institucionais e custos de transação em parcerias público-privadas. In: GOMIDE, Alexandre de Ávila Gomide e Ana Karine Pereira (*Governança da política de infraestrutur*a, op. cit., p. 115).

[20] Ronaldo Fiani, *Arranjos institucionais e custos de transação em parcerias público-privadas*, op. cit., p. 116.

Opportunistic behaviour can occur before or after the contract is signed. If before, an adverse selection situation is created, as whomever is privy to the information may seek to gain advantage.

In public tenders, adverse selection occurs mainly when the object is highly complex, as the technical and economic qualification criteria are insufficient to assess asymmetry and expose the real potential of the contractor to carry out the work. In the bidding process, there are no mechanisms to ensure effective information, because, as administrative contracts are binding, the draft is pre-established in the public notice and there is no possibility of bargaining between the parties about certain clauses.[21]

It cannot be forgotten that information asymmetry can occur in different situations in different sectors of the economy. For example, workers know more about their skills than the hiring company; a person contracting a health insurance company knows more about their medical condition; the owner of a car knows more about the features of its car than potential buyers; and the company's CEO holds more information than the investors etc.[22]

Adverse selection is a topic of serious research, especially in the area of insurance. Also known as anti-selection, it refers to a procedure in which asymmetric information possessed by one of the parties will secure an advantage in the negotiations, i.e., one of the parties has insufficient knowledge of the circumstances of the contractor, making decision-making difficult.

Attentive to the theme, Paulo Pereira Ferreira[23] points out that the insured also has difficulty in quantifying the risk to which they are exposed. To mitigate the consequences of adverse selection, the insurer uses actuarial techniques to quantify the risks, which are priced with a certain safety margin. The insurance contract, therefore, may become acceptable to the insured given the various coverage options presented by the insurer, vis-a-vis the option that best fits the interests of the insured. The author highlights the importance of the "Theory of Economic Utility" as a justifying hypothesis for the insured to accept payment of a premium to the insurer that is greater than the average value of loss due to the large reduction in its utility function in case of an accident.[24]

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21 TIMM, Luciano Benetti (Org.). *Direito e economia no Brasil*. 2. ed. São Paulo: Atlas, 2014. p. 409.

22 STIGLITZ, Joseph E. Information and the change in the paradigm in economics. *The American Economic Review*, Pittsburgh, v. 92, n. 3, p. 469-470, jun. 2002.

23 FERREIRA, Paulo Pereira. *Seleção adversa*. 2020. p. 29. Available at: https://cadernosdeseguro.ens.edu.br/pdf/cadseg197v2selecaoadversa.pdf. Accessed on: 31 May 2021.

24 Ibid., p. 30.

In insurance contracts, adverse selection occurs more frequently, as the insured has accurate information on the main risks, not always disclosed to the insurer. It is up to the insurer to effectively manage the mechanisms that reveal information and look for windows of opportunity resulting from the proposals presented to the insured.[25]

However, when information asymmetry arises after the signing of the contract, the moral hazard hypothesis occurs. Moral hazard is related by doctrine to the so-called agency problems,[26] in which one party, an agent, must represent the interests of another, the principal, or main party. In certain situations, the agent will receive incentives to act opportunistically, contrary to the will of the principal, without possibility to monitor the harmful conduct.

The moral hazard problem can occur in contracts between companies (external moral hazard), or within the same company (internal moral hazard). Per-Erik Eriksson and Hans Lind argue that external moral hazard occurs in cases in which one company behaves opportunistically towards another. For example, the contractor acts without care or effort, starts to replace more expensive materials with cheaper and lower quality ones, registers more work than was actually done, etc. Likewise, the contractor may also practice opportunistic behaviour - not making the payment according to the agreed conditions, demanding work not contractually foreseen, refusing to approve a service that meets all the parameters of the agreement.[27]

Therefore, internal moral hazard occurs inside a company and can occur at different hierarchical levels. Internal opportunism is identified when the employee enters into a contract without the necessary approval, or when not following orders concerning the quality of work and safety, especially when performance results from lack of effort or knowledge or acts of corruption.[28]

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[25] Ibid., p. 33.

[26] Clara Oliveira and Joaquim Rubens Filho point out that agency costs can arise from three sources: (i) monitoring costs; (ii) obligation costs; and (iii) residual losses. For the authors, the list of monitoring costs is not exhausted with measurement and observation of direct actions of the agent, including also efforts to control agent actions through budget constraints, compensation policies, operation rules, audits, training, etc. (OLIVEIRA, Clara Brando de; FONTES FILHO, Joaquim Rubens. Problema de agência no setor público: o papel dos intermediadores da relação entre poder central e unidades executoras. *Revista de Administração Pública*, Rio de Janeiro, v. 51, n. 4, p. 600, jul./ago. 2017.).

[27] ERIKSSON, Per-Erik; LIND, Hans. *Moral hazard and construction procurement*: a conceptual framework. 2015. p. 5. Available at: https://ideas.repec.org/p/hhs/kthrec/2015_002.html. Accessed on: 3 Jun. 2021.

[28] Lind Eriksson, *Moral hazard and construction procurement*, op. cit., p. 6.

A classic example of moral hazard occurs in the situation where a person signs an insurance contract for their vehicle and, after the first few months, becomes incautious, not parking in a safe space, not using trackers, etc. Hence, to avoid opportunistic conduct, insurers use mechanisms to ensure caution through the application of a deduction or even an increase in future prices in view of the impossibility of inspecting the insured, to achieve a risk matrix according to the initial parameters of the contract.

The difficulties and risks in the selection of bidders to execute public works are immense. Hence, performance bond contracts are complex, hybrid in nature with certain peculiarities, involving rights and obligations of a trilateral nature. In these contracts there are three parties: the policyholder, responsible for delivering the work; the insurer, who in cases of default will guarantee the execution of the work and be responsible for the contractually guaranteed amount; and the public entity.

As evidenced by Francisco Galiza,[29] in the insurance contract, traditionally, the insurer waits for the claim to occur and prices this risk. In performance bond contracts, the claim rate must be zero. If there is probability of risk in the performance of the contract, the bond is not signed. Hence, in these contracts, the premium charged by the insurer is intended to cover the cost necessary to mitigate information asymmetries between the parties, with respect to the technical, financial and operational capacity of the agent contracted to execute the work.

James Vieira, Renata Macedo and Hermann Hrdlicka[30] also point out some differences between regular insurance and performance bonds. The authors argue that in relation to the expected losses resulting from an accident two perspectives may be verified. In traditional insurance contracts, the insurer performs actuarial calculations to establish a loss margin according to a set of factors and rates adjusted according to market fluctuations. As for losses in performance bonds, the insurer does not have this expectation, because, as pointed out, the loss ratio must be zero. There will only be a performance bond contract when there is a wide margin of safety; before the verification of possible risk in the operation, the insurance will not be issued.

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[29] Francisco Galiza, *Uma análise comparativa do seguro garantia de obras públicas*, op. cit., p. 17.

[30] VIEIRA, James Batista; MACEDO, Renata Gomes de; HRDLICKA, Hermann Atila. A relevância do seguro garantia nas compras públicas. *Revista Brasileira de Políticas Públicas e Internacionais*, João Pessoa, v. 4, n. 2, p. 227, nov. 2019.

Furthermore, the authors highlight another important distinction regarding the calculation of the premium. In ordinary insurance contracts, the premium is estimated according to actuarial valuations according to the type of the object of the insurance; this analysis is not related to any project or the financial capacity of the insured. On the other hand, performance bonds calculate the premium according to the characteristics of the policyholder, analyzing capacity to execute the work.[31] The premium, therefore, pays the costs that the insurer will incur in assessing the policyholder's condition, as well remuneration of the insurance company for its "quality seal" to the project.

David Raick identifies a certain similarity between performance bonds and surety. The author points out that, as with surety, the performance bond is made up of a tripartite relationship: internal (main contract establishing insured obligations), external (creditor-guarantor in a *fidejussury* guarantee) and a temporary one (guarantor-debtor). Others point out characteristics that resemble surety: the guaranteed obligation is an obligation to perform; it is subsidiary and accessory to the obligation contractually provided for; and the guarantor and insurer will subrogate to each other the creditor's rights to pay the indemnity or to undertake the performance of the work.[32]

In fact, the performance bond modality, considering the complexity of its structuring, is a unique kind of insurance, with its own characteristics, and must be carried out by an insurance company specialised in that market. The need for constant monitoring of the work, especially public works, is essential to avoid failures in execution and ensure that obligations are met.

The more specialised the insurer is in the insurance market, the better the choice of companies that will be able to issue a policy. Hence the importance of performance bonds to reduce asymmetry of information in the bids and to prevent disreputable agents carrying out costly public works.

In the performance bond, a seal of security is bestowed on the borrower, vis-a-vis their ability to perform the contract. The insurer functions as a sort of rating or certification agency, vouching that it has carried out due diligence on the borrower and has sufficient reason to believe the contract will be fully

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[31] Ibid., p. 227.

[32] David Raick, *O uso de fidejussão como garantia do adimplemento das obrigações em contratos de obra pública*, op. cit., p. 91-92.

executed. The bond works as an instrument for disclosing information, in the face of pre-qualification and traditional eligibility criteria.

4. Final considerations

Law 14.133/2021 promoted execution of public contracts, so that, among the modalities provided for by law, the performance bond gained prominence. The expansion of the percentage required for insurance coverage to the level of up to 30% represents a relative improvement, therefore, following the US paradigm. Thus, the value of the insurance must correspond to levels between 50% and 100% of the initial value of the work contract.

The context of the two countries vis-a-vis the insurance market is different, since its use is more consolidated in the USA, with the enactment of the Heard Act in 1894. Nevertheless, the performance bond instrument can generate incentives to allow, through this trilateral relationship between the policyholder, insurer and insured, works and services to be performed under the terms that were initially agreed, reducing delays in contractual execution and endless unfinished works.

Art. 102, of Law no. 14,133/2021, could have adopted a more incisive approach, to establish a duty and not a mere faculty of public administration for the use of performance bonds in contracting major works. Using the expression "the public notice may require", the law lends room for interpretation so that the various public administration managers may choose whether or not to use this modality in the case of major works.

If the domestic insurance market is made up of companies capable of modelling and overseeing performance bonds, the generated incentives can contribute to reduce information asymmetry and, similarly, avoid unwanted accidents in the execution of public contracts.

Finally, it should be noted that the insurers will agree to performance bond contracts only with companies that demonstrate a high level of technical reliability in carrying out the work, i.e., when there is wide margin of safety and a zero risk of the occurrence of an accident, deterring those unable to meet to the insurer analysis parameters. If well structured, performance bonds can contribute to monitoring of the execution of the work and to the fight against opportunistic practices, including attempts at contractual readjustments to excessively increase the final value of the work.

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