



THE APPLICABLE LAW FOR STANDBY LETTERS OF CREDIT IN THE COLOMBIAN LEGAL SYSTEM

CAMILO ANDRÉS CAICEDO CALLE

Artículo de reflexión

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Abstract

The objective of this research is to determine the law applicable to standby letters of credit in Colombia. Such research seeks to resolve the controversy found when applying uniform international regulations to standby letters of credit in local transactions. In order to accomplish this objective, I begin this paper by first posing the research question, then defining the term “standby letter”, and finally analyzing the applicable law. I conclude that the nature of standby letters of credit is not one of a suretyship, as the Financial Superintendence of Colombia argues, and therefore Colombian regulation of suretyships should not be applied to standby letters of credit because they contradict the very essence of this instrument. Rather, I argue that parties should incorporate uniform international regulations, which have been issued specifically to govern this instrument.

Key words: applicable law, guarantees, independent guarantees, ISP98, standby letter of credit, suretyship, UCP 600.

Ley aplicable a las cartas de crédito *standby* en el sistema jurídico colombiano

Resumen

El objetivo de este trabajo de investigación es determinar cuál es la ley aplicable a las cartas de crédito *standby* en Colombia. Esto busca resolver la controversia en torno a la aplicación de regulaciones internacionales uniformes a cartas de crédito *standby* en transacciones locales. Para cumplir con este objetivo, en primer lugar se planteará una pregunta de investigación, en segundo lugar se definirá la carta de crédito *standby* y por último se analizará la ley aplicable. Después de seguir esta metodología, se concluirá que la naturaleza de las cartas de crédito *standby* no es la de una fianza, como la Superintendencia Financiera argumenta. Esto significa que las regulaciones colombianas relacionadas con la fianza no deben ser aplicadas a las cartas de crédito *standby*, porque se contradicen con la esencia de este instrumento. En vez de eso, las regulaciones internacionales uniformes emitidas específicamente para reglamentar este instrumento deberían incorporarse a él por las partes.

Palabras clave: carta de crédito *standby*, fianza, garantías, garantías independientes, ISP98, ley aplicable, UCP 600.

Lei aplicável às cartas de crédito *standby* no sistema jurídico colombiano

Resumo

O objetivo deste trabalho de pesquisa é determinar qual é a lei aplicável às cartas de crédito *standby* na Colômbia. Isto busca resolver a controvérsia em torno da aplicação de regulações internacionais uniformes a cartas de crédito *standby* em transações locais. Para cumprir com este objetivo, em primeiro lugar será formulada uma pergunta de pesquisa, em segundo lugar será definida a carta de crédito *standby* e por último será analisada a lei aplicável. Depois de seguir esta metodologia, será concluído que a natureza das cartas de crédito *standby* não é a de uma fiança, como a Superintendência Financeira argumenta. Isto significa que as regulações colombianas relacionadas com a fiança não devem ser aplicadas às cartas de crédito *standby*, porque se contradizem com a essência deste instrumento. Em vez disso, as regulações internacionais uniformes emitidas especificamente para regulamentar este instrumento deveriam incorporar-se a ele pelas partes.

Palavras-chave: carta de crédito *standby*, fiança, garantias, garantias independentes, ISP98, lei aplicável, UCP 600.

The applicable law for standby letters of credit in the Colombian legal system*

Camilo Andrés Caicedo Calle**

SUMMARY

I. INTRODUCTION – A. Research Question – B. Standby Letter of Credit Terminology – C. Definition of Standby Letter of Credit – II. APPLICABLE LAW – A. International Regulation – B. UCP 600 – C. ISP98 – D. National Regulation – E. Code of Commerce – F. Civil Code – G. Financial Superintendence 007 Basic Legal Circular of 1996 – H. Standby LCs in Government Contracts – I. Lack of Regulation – J. Guidelines – K. Assessment – III. CONCLUSIONS – Bibliography.

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** Camilo Andrés Caicedo Calle holds a law degree from Los Andes University in Bogotá, Colombia and is currently employed as a junior associate at Rodríguez-Azuero Abogados. E-mail: ccaicedo@rodriguezazuero.com.

I. INTRODUCTION

This research process arose out of a controversy whose decision will provide the applicable law to standby letters of credit in Colombia. One side argues that Colombian law should apply, but uniform international regulations, such as the ISP98 (International Standby Practices) and the UCP 600 (Uniform Customs and Practice for Documentary Credits) are also applicable, as long as there is a clause in the letter that incorporates them. The other side states that these international regulations are not applicable law because they contradict Colombian public policy rules regarding suretyship regulations (*fianza*).

A. Research Question

This paper seeks to resolve this controversy by asking whether it is acceptable under the Colombian legal system to incorporate uniform international regulations into a standby letter of credit in a local transaction.

B. Standby Letter of Credit Terminology

Although banking practices have become globalized and tend to take a uniform approach, terminology surrounding such practices differs from civil to common law. Therefore, before delving into the substance of this topic, it is necessary to first understand the terminology used in these two different legal systems.

The entire area of guarantees is marked by confusion. The “independent guarantee” emerged

from practice, but it was unknown by the law. Traditional personal security served as an accessory to the main obligation and was commonly known as a “suretyship”. However, banking practices also referred to this “suretyship” as a guarantee. The interchangeable use of these two very distinct terms thus resulted in a great deal of befuddlement (Bertramps, 2004, p. 4).

In civil law, codified laws and case law separate the concepts of accessory suretyships and independent guarantees. However, this is an abstract difference that in practice provides almost no aid to bankers and lawyers concerned with how these instruments take effect. For example, must they assess whether the debtor has unfulfilled its obligation or simply submit documentation provided by third parties, or must they submit their own documents? In conclusion, the classification between accessory suretyships and independent guarantees is irrelevant as each is used indistinctly in practice (Bertramps, 2004, p. 200).

In common law, accessory suretyships and independent guarantees are respectively defined as follows: “the guarantee (or guaranty) being the accessory type of security and the standby letter of credit being the independent type of security. (...) The extent of co-extensiveness or independence and the rights and obligations of parties can only be derived from the particular terms and conditions of the bond” (Bertramps, 2004, p. 200). Therefore, if one must determine whether a security is independent or accessory, the terminology provided in the letter or contract is insufficient; instead one must analyze the terms and conditions of the bond.

The common law term “standby letter of credit” (standby LC) is equivalent to the civil law term “independent guarantee” (Bertramps, 2004, p. 4). The standby LC originated in the United States. Under the National Bank Act of June 3, 1864, banks were not authorized to answer for their clients’ debts as the issuance of guarantees was an activity solely authorized to insurance and bonding companies. In order to circumvent this prohibition, U.S. banks issued bills of exchange and letters of credit (which fell under their authorized transactions), which in appearance were not guarantees, but in substance fulfilled the same purpose. “This practice became gradually well-established and remained largely unopposed” (Bertramps, 2004, p. 6). As this practice became more common, the question about what kind of guarantees banks could issue arose. It was still believed that banks could not issue these types of securities, because it would have to engage in an investigation regarding the default of the principal and secondary debtor - an activity they were not qualified nor prepared to do. This problem was resolved when the banks’ liability was to be determined “solely by reference to the terms of its undertaking payment, in particular where the tender of certain documents was the event that would trigger the payment without reference to the terms of the underlying transaction, and whether the decision to issue the undertaking depended on the usual investigation of the account party’s creditworthiness” (Bertramps, 2004, p. 6). American Banks received authorization to issue the securities described above under the final revised Interpretative Ruling 7.1016 of the Comptroller

of Currency on February 9, 1996 (Bertramps, 2004, p. 6).

Since then traditional letters of credit refer to means of payment in sales transactions, and “standby letters of credit” refer to a security for default, which has an independent and documentary nature (Bertramps, 2004, p. 6). This terminology has been used in Latin American and Far Eastern countries that employ North American banking practices¹. Therefore, U.S. standby LCs are equivalent to civil law independent guarantees.

C. Definition of Standby Letter of Credit

I now will address how guarantees are dealt with in Colombia. Historically, guarantees in Colombia were categorized as either personal and *in rem* (Ustáriz González, 2004, p. 7). However, as commerce became more complex, the following categories of guarantees emerged: (i) Personal guarantees: these include the suretyship and the co-signature; (ii) Exchange guarantees: these occur through the incorporation of credits into instruments such as bills of exchange and promissory notes; (iii) Mortgage guarantees: these involve real estate, ships and aircraft; and (iv) Collateral guarantees: these relate to securities collateral or movable assets (Ustáriz González, 2004, p. 7). Guarantee instruments also adopted a wide variety of categories, such as: bank guarantees, parent company guarantees, letters of awareness, on first demand guarantees and standby LCs (Ustáriz González, 2004,

¹ Such as Colombia.

p. 7-10). Before focusing on the last instrument, a short definition of the other instruments will be provided.

Financial institutions issue bank guarantees or bank endorsements. These instruments, although categorized as bank guarantees, also possess certain characteristics that make them similar to a security. Bank guarantees seek payment of an exchange obligation that is incorporated into the security, which instills confidence to the security's new owners. The guarantor's obligation is independent from the guarantee's obligation and is to the same extent (either directly or in return). Therefore, the endorsement holder can require payment interchangeably from any of the signatories, including the guarantor. Further, the guarantor is not affected if the guarantee's obligation is null and void (Ustáriz González, 2004, p. 8).

Parent company guarantees are issued by the parent company of a subsidiary and ensure that the parent company will answer for any breach of obligation by its subsidiary. Parent company guarantees are normally issued by multinational companies, which are governed by the laws of the country in which the parent company is incorporated, but must comply with the laws of the foreign jurisdiction in order to be effective (Ustáriz González, 2004).

Letters of awareness are written statements by the subsidiary addressed to the credit institution, or to any other entity that supports the financing or the negotiating process. These letters are not bank guarantees because in this

situation the bank is the receiver of the statement. Letters of awareness are classified as: i) declaratory clauses; ii) maintaining shareholder clauses; iii) subordinated control clauses; and iv) financial support clauses (Ustáriz González, 2004, p. 9-10).

On first demand guarantees, unlike civil law guarantees, are independent from the main obligation and allow financial institutions to serve as guarantors. Once an on first demand guarantee has been issued it becomes a separate obligation between the bank and the beneficiary, hence the bank is not working to fulfill the debtor's obligation, but rather it guarantees the obligation in exchange for a commission. On first demand guarantees also differ from suretyships (*fianza*) in that under a security the guarantor's obligation becomes effective if the main debtor breaches the guarantee's obligation (Ustáriz González, 2004).

Letters of credit serve as vital global commerce instruments. Many of the most important transactions are guaranteed with these types of letters (Sifri, 2008, p. xiii). Their main objective is to transfer the contractual risk from one party to another in a credit transaction. A standby LC is a type of a letter of credit that takes the form of a compliance assurance becoming effective whenever the guaranteed obligation is unfulfilled (Maximiliano Rodríguez Fernández & Arias Barrera, 2009, p. 23) (Dole Jr., 2002, p. 381). Standby LCs are granted by a bank on demand by the seller in favor of the buyer of the merchandises (payee), and they become effective upon submission of a document that certifies

the buyer's unfulfilled obligation of delivering the merchandises. The purpose of a standby LC is not to ensure that the seller gets paid, but to ensure that the seller performs (Folson, Wallace, & Spanogle, Jr., 2005, p. 158).

The same substantive laws and practice govern standby letters and regular letters of credit. Nevertheless, they differ in many ways. The main difference lies in how the documents must be submitted in order to become operative. In order for a regular LC to become effective, one must submit documents that show the beneficiary has performed the obligation. Conversely, in order for a standby LC to become effective, one must submit documents that show that the principal has failed to perform (Folson, Wallace, & Spanogle, Jr., 2005, p. 159). In the regular LC, the documentation required to demand the settlement is generated by a third party (bill of lading), while in a standby LC, the beneficiary generates all the documentation required².

Another difference between these two types of LCs is that in the standby LC the beneficiary demands payment only when the customer fails to fulfill the underlying obligation. Alternatively, in the regular LC the beneficiary may demand payment in a number of situations, including when the customer fails to fulfill the underlying obligation.

A bank also runs more of a risk with standby LCs than with regular LCs. "The standby letter of credit is primarily a risk-shifting device, with

² "Usually a simple statement that the customer is in default" (Folson, Wallace, & Spanogle, Jr., 2005, p. 160)

the advantage of providing the beneficiary with swift and easy access to funds in the event of a customer's default, much as if the customer had left a cash deposit with the beneficiary." (Folson, Wallace, & Spanogle, Jr., 2005). With standby LCs, the bank cannot verify or investigate the actual default of its customer. Rather, it must simply verify the required documents and pay the customer upon his/her demand. Fraud is the only valid exception to deny payment of a standby LC. Usually, a standby LC is unfunded meaning the customer guarantees the bank will be "reimbursed if it is forced to pay out the letter" (Folson, Wallace, & Spanogle, Jr., 2005, p. 160).

II. APPLICABLE LAW

A. *International Regulation*

Standby letters of credit are issued using two international regulations: the UCP 600 and the ISP98. However, the UCP 600 rules mostly focus on regulating commercial letters of credit while the ISP98 sets forth, "a complete set of rules that represent the practice of international banks in handling standby LCs. [These rules] were drafted by a group of experts and sanctioned by the International Chamber of Commerce (ICC); hence, they are globally recognized by all banks" (Sifri, 2008, p. 3).

B. *UCP 600*

The UCP is a compilation of international customs and practices created by the International Chamber of Commerce. "UCP 600 is the latest

revision of the Uniform Customs and Practice that govern the operation of letters of credit. The UCP 600 came into effect on July 1, 2007. The 39 articles of the UCP 600 are a comprehensive and practical working aid to bankers, lawyers, importers, and exporters, transport executives, educators, and everyone involved in letter of credit transactions worldwide” (International Commerce Chamber, 2007). The UCP 600 was issued because under the UCP 500 documents were usually rejected due to technical reasons. The ICC recognized that the UCP 600 provided better definitions and improved interpretations and accordingly changed the rules for examination of submitted documents (Wood, 2008, p. 105). The UCP 600 focuses on commercial LCs, but it is applicable to all types of letters of credit.

C. ISP98

The ISP98 codifies international banking practices when they issue and negotiate standby LCs. The ISP98 rules are “often easier and clearer to apply than UCP rules in the context of standby letters of credit” (Scranton, 2007, p. 130).

The first rule of the ISP98 defines the scope, application, definitions, and interpretation of the remaining provisions (International Commerce Chamber, 1998). The ISP98 applies to standby LCs, which include performance, financial, and direct payment standby LCs, but it can also apply to other similar undertakings, such as infrastructure and mining projects³. In performance standby LCs, the petitioner must fulfill

a positive obligation, like the construction of a building. The financial standby LC requires the applicant to pay its debt in a lump sum and the direct payment standby LC obliges the issuer to pay “principal, interest or both when a financial instrument becomes due or upon redemption. The default coverage is meant to protect against insolvencies of the issuer of the securities or the debt instrument” (Sifri, 2008, p. 10). These rules only apply if the parties expressly reference them in the LC⁴. The parties may also exclude the application of certain ISP98 rules if such exclusion is clearly expressed in the LC’s text⁵.

The relationship between ISP98 and other regulations is varied, as it supersedes the UCP 600, but is subordinate to national laws⁶. For example, when the ISP98 contradicts commercial or banking laws, letters of credit or any other national laws, the national laws supersede the rules of the ISP98. However, when ISP98 contradicts other rules of practice (like the UCP 600) when referring to standby LCs, the ISP98 provisions take precedence. If the contradiction occurs under a commercial LC, the ISP98 provisions will not prevail.

The ISP98 is a rule of practice, which means it governs mercantile usage by international banks in standby LC transactions⁷ (Sifri, 2008, p. 12). The ICC issued these rules in order to unify a

3 Article 1.01 a. ISP98

4 Article 1.01 b. ISP98

5 Article 1.01 c. ISP98

6 Article 1.02 a. and b. ISP98

7 Article 1.03 ISP98

trustworthy payment system that guarantees the rights of the parties involved in international commerce transactions. These rules were not issued by any particular country's legal system and should be understood and interpreted as commercial practice. Rather, "the ISP98 must always be interpreted in the context of a reliable and liquid instrument used to avail immediate payment to the beneficiary upon presentation of a simple demand without having to go beyond checking the demand sheet on its face to ensure that it complies with the standby terms and conditions" (Sifri, 2008, p. 12). Thus, banks cannot dishonor their obligation to pay under national laws. Rather, they can only propose the fraud exception when involved in a court dispute. However, the interpretation of these rules by a country's legal system is prohibited.⁸ Since the ISP98 rules are practices and terminology of banks and businesses in day-to-day transactions⁹ a legal interpretation "would contradict their purpose and may create harmful complications" (Sifri, 2008, p. 12).

Whenever a standby LC is issued under ISP98 provisions, these rules will apply to all the parties that intervene in the transaction¹⁰. These parties include: "the issuer, the beneficiary to the extent it uses the standby, any advisor, any confirmer, any person nominated in the standby who acts or agrees to act, and the applicant who authorizes issuance of the standby or otherwise

agrees to the application of these rules" (International Commerce Chamber, 1998). Matters regarding Due Issuance and Fraudulent or Abusive Drawing of the standby LC are expressly excluded from the ISP98, and are left to the national applicable law¹¹.

According to the ISP98, the general principles of the standby LCs are divided into three categories: i) the nature of standbys LCs; ii) the independence of the issuer-beneficiary relationship; and iii) the limits to liability. The nature of a standby LC¹² is an undertaking that is "irrevocable, independent, documentary, and binding when issued and need not so state." (International Commerce Chamber, 1998). It is irrevocable because an issuer cannot modify or cancel its obligation, unless it follows the standby provisions, or unless the person "against whom the amendment or cancellation is asserted¹³" consents (International Commerce Chamber, 1998). It is independent because the effectiveness of an issuer's obligation does not depend on the reimbursement issuer's right, the beneficiary's right, a reference in the standby to any reimbursement agreement or underlying transaction, or the issuer's knowledge or performance or breach of any reimbursement agreement or underlying transaction¹⁴. The nature of a standby LC is documentary in that the issuer's obligation depends on the submission

8 Article 1.03. d. ISP98

9 Article 1.03 b. ISP98

10 Article 1.04 ISP98

11 Article 1.05 ISP98

12 Article 1.06 ISP98

13 Article 1.06. b. ISP98

14 Article 1.06. c. ISP98

of documentation and the examination of such documents on their face¹⁵. Lastly, the nature of a standby is binding upon the issuer when issued regardless of whether the applicant authorized its issuance, the issuer received a fee, or whether the beneficiary received or relied upon the standby or the amendment¹⁶.

The independence principle is the most important characteristic of any letter of credit because it provides that payment under a letter of credit will be made only after examining the documents called for in the letter of credit, regardless of any rights and obligations between the beneficiary and the applicant, or the issuer and the applicant¹⁷. In other words, this principle implies that the issuer must not take into account anything other than the compliance of the documents with the terms and conditions provided in the letter of credit. For example, the issuer is not entitled to examine whether the beneficiary has the right to demand payment under the subjacent obligation between the parties in the letter of credit.

The liability of the issuer of a standby LC is limited. Thus, the issuer is not responsible for the fulfillment or breach of any underlying transaction, nor is the issuer responsible for the characteristics of any document submitted under the standby, or the behavior of others even if the issuer chooses them. The issuer is also not responsible

for compliance with any law or practice different than the one incorporated into the standby LC or applicable at the place of issuance¹⁸.

The ISP98 also provides several definitions for terminology affiliated with standby LCs¹⁹. The most relevant are the following:

- i. Applicant: The person who requests issuance of the letter of credit. This includes a person applying in his/her own name on behalf of another person or an issuer acting on its own behalf.
- ii. Beneficiary: The person who has the right to require the payment of the standby.
- iii. Confirmer: An additional undertaker of the standby, nominated by the issuer.
- iv. Demand: Either a request for payment of a standby, or the document that makes such request.
- v. Document: Any representation of law, fact, right or opinion, which upon presentation²⁰ can be examined for compliance with the terms and conditions of the standby.

ISP98 does not define the term “issuer” therefore the issuer may be any person or entity. Even though the drafters assumed that the issuer would be a bank, there is no rule that excludes

15 Article 1.06. d. ISP98

16 Article 1.06. e. ISP98

17 This principle is stated in UCP 600 Arts 4(a) and 5, and in the ISP98 Rule 1.06 (c) and 1.07.

18 Article 1.08 ISP98

19 Article 1.09 ISP98

20 The presentation may be in a paper or in an electronic medium.

non-bank persons from being issuers. Conversely, the UCP 600 requires the issuer to be a bank. However, Art. 1 provides that the parties may freely modify the UCP provisions, which permit them to agree to a non-bank issuer (Wood, 2008, p. 114).

The second rule of the ISP98 sets forth the issuer's obligations in a standby LC. The general obligation of the issuer is to honor a presentation²¹ that appears on its face to comply with the standby's terms and conditions. It is important to note that this is just a formal verification, not a substantive one and is similar to the verification that the exchange debtor must exercise in order to determine the legitimacy of a security holder and thereby honor the exchange obligation (Trujillo Calle, 2012, p. 59). The issuer honors the presentation by paying the amount demanded unless the standby LC provides a different procedure. There are three different ways to honor a presentation:

- i. By acceptance of a draft drawn by the beneficiary on the issuer. In this case, the honoring of the standby will be accomplished by timely acceptance of the draft and thereafter paying the draft holder²².
- ii. By deferred payment, which is honored by timely incurrence of a deferred payment obligation and thereafter paying at maturity²³.

21 A presentation is when the holder of the standby LC requires payment to the issuer bank.

22 Article 2.01. b. i. ISP98

23 Article 2.01. b. ii. ISP98

- iii. By negotiation, in which case the issuer honors the standby by paying the amount demanded without recourse.

The term "to honor a standby LC" is provided in ISP98 Rule 5.01. According to this rule, the notice of dishonor must be sent within a reasonable time (not exceeding seven business days) from the date of presentation of the standby.²⁴

Unless otherwise stated, a standby LC is considered issued when it leaves the issuer's control. "Once the standby leaves the control of the issuer, it becomes an irrevocable binding instrument unless the standby states otherwise" (Sifri, 2008, p. 31). These conditions must be incorporated into the standby LC, otherwise they will be considered non-documentary²⁵, and therefore disregarded (Sifri, 2008, p. 31). A standby LC cannot include a non-documentary condition. "A non-documentary condition exists when a credit sets forth a condition to be satisfied before the beneficiary may draw upon the credit but does not set forth a document to be delivered to the issuer to establish the satisfaction of the condition" (Wood, 2008, p. 117). The UCP 600 expressly forbids "non-documentary" conditions, providing that unless a letter of credit incorporates such conditions, it must be disregarded. ISP98 Rule 4.11 also states that this type of condition must be ignored, but provides an exception when conditions can be determined by the issuer from the issuer's own records or within its normal operations, including the con-

24 Article 5.01 ISP98.

25 Article 4.11 ISP98.

sultation of published indexes (Wood, 2008, p. 117).

Sometimes, the issuer nominates another bank (usually a bank located in the beneficiary's domicile), to perform a specific task. This task might be "giving advice, receiving a presentation, effecting a transfer, or confirming, paying, negotiating, or incurring a deferred payment obligation, or accepting a draft²⁶" (International Commerce Chamber, 1998). The nominated person must accept the task in order to be bound by it and the nominated person cannot bind the person who nominates him²⁷.

ISP98 Rule 3 regulates the presentation of the standby LC. The issuer must honor its obligation only when the documents are presented under the terms and conditions of the standby LC. A standby LC should indicate the time, place and location within that place and the medium of presentation. The standby may also name the person to which the presentation must be submitted (Sifri, 2008, p. 38). "The receipt of a document required by and presented under a standby constitutes a presentation requiring examination for compliance with the terms and conditions of the standby even if not all of the required documents have been presented²⁸" (International Commerce Chamber, 1998). This means that the beneficiary may present all or part of the documents required, and the issuer

or person nominated must still perform the examination. This examination must be done in the time provided under Rule 5.03 and must determine whether the documents comply with the standby LC provisions. If the issuer or person nominated fails to decide this matter within the timeframe provided, it "will be precluded from claiming that the documents are not compliant and will be obliged to honor [the standby LC's] value" (Sifri, 2008, p. 39).

To avoid unnecessary delays, the presentation must clearly identify the standby LC that requires such presentation. This identification can be performed by clearly stating the standby LC's complete reference number and the issuer's name and location, or by attaching the original or a copy of the standby LC to the presentation²⁹. The issuer is not it obliged to perform a search for the standby LC, nor must it check the presentation until the standby LC is fully identified. If the standby LC expired before the presentation was identified, the issuer will consider it a late presentation and the beneficiary shall assume responsibility³⁰. The presentation must be done at the place indicated in the standby LC. If a place is not indicated in the standby LC, the presentation must be made at the place of business from which the standby LC was issued³¹. The presentation must be done at any time after the issuance and before the expiration date³².

26 Article 2.04. a. ISP98

27 Article 2.04. b. ISP98

28 Article 3.02 ISP98

29 Article 3.03. b. ISP98

30 Article 3.03. c. ISP98

31 Article 3.04. b. ISP98

32 Article 3.05 ISP98

It must be presented in the means indicated by the standby LC. If it does not provide a mean, it must be presented as a paper document, unless only a verbal demand of payment is required³³.

ISP98 Rule 4 outlines the rules governing document examination. A demand to honor a standby LC must comply with the standby LC's terms and conditions. The examination must be done on its face against the terms and conditions provided in the standby LC and must be in accordance with ISP98 rules; the ISP98 provisions are supplementary to the standby text (Sifri, 2008, p. 59). If there are several persons who must perform an examination (issuer and nominated bank), each person is responsible for making its own examination. Documents not required by the standby LC are not subject to examination³⁴. As a general rule, a beneficiary must issue the documents, unless the standby provides that a third party must issue them³⁵. The documents need not be signed, unless the standby requires it, then the signature must be made in a matter that corresponds to the mean in which the signed document is presented³⁶. If a standby does not require the presentation of any document, it is still necessary to present a documentary demand for payment³⁷. A standby must not require a document that must be issued by the applicant

of the standby³⁸. ISP98 Rule 4.10 seeks to prevent the standby from becoming an inoperative instrument. A standby term or condition should be disregarded if it is non-documentary³⁹.

A required statement, as a general rule, needs no formality. Nevertheless, the standby LC can provide an additional formality, such as a sworn oath, a witness or a counter-signature from a government representative⁴⁰. When the issuer or the person deemed to perform the honoring of the presentation determines it complies with the standby LC's provisions, it is not obliged to verify the identity of the beneficiary⁴¹. The issuer or the person's payment to the named beneficiary fulfills its obligation.

There are several types of standby documents:

- i. Demand for payment: This demand does not need to be separated from the beneficiary's statement or other required document. If it is required as a separate document, it must contain a demand for payment from the beneficiary to the issuer, the date of the demand issuance, the amount and the beneficiary's signature⁴².
- ii. Statement of default or other drawing event: These must contain a representation to the

33 Article 3.06 ISP98

34 Article 4.02. ISP98

35 Article 4.05 ISP98

36 Article 4.07 ISP98

37 Article 4.08 ISP98

38 Article 4.10 ISP98

39 Article 4.11 ISP98

40 Article 4.12 ISP98

41 Article 4.13 ISP98

42 Article 4.16 ISP98

effect that payment is due because a drawing event described in the standby LC occurred, the issuance date and the beneficiary's signature⁴³.

- iii. Negotiable documents: If the document is transferable by endorsement and delivery, it must be presented without endorsement or with a blank endorsement. The document may be issued or negotiated with or without recourse⁴⁴.
- iv. Legal or judicial documents: These documents include government issued documents, court orders, arbitration awards, etc. A government institution must issue them; they must be suitably titled, signed, and originally certified by an official of a government institution⁴⁵.
- v. Other documents: If a document differs from the ones listed above and is required in a standby LC, it will comply if it appears to be properly titled or to serve the purpose of that type of document under standard standby practices.

ISP98 Rule 5 regulates the notice, preclusion and disposition of documents. A notice of dishonor must include all the reasons that support the dishonor and must be presented within seven business days after the documents have been

43 Article 4.17 ISP98

44 Article 4.18 ISP98

45 Article 4.19 ISP98

presented⁴⁶. The issuer is precluded from asserting any discrepancy contained in the documents if it fails to detect an inconsistency within this timeframe and by the means provided in the standby LC (Sifri, 2008, p. 90) and must pay at maturity⁴⁷. If the issuer delivers a notice of dishonor in a timely manner, the presenter of the documents may request the applicant to waive non-compliance or to authorize the honor within the time available for giving notice of dishonor. However, the applicant's waiver does not force the issuer to waive non-compliance⁴⁸. An applicant may object the issuer's honor of a non-complying presentation by giving timely notice to the issuer⁴⁹.

ISP98 Rule 6 regulates the assignment and transfer by operation of law of the standby LC. A standby LC is not transferable unless it so states. If it is transferable, it can be transferred as many times as desired, but cannot be partially transferred⁵⁰. The issuer or the person nominated by the standby LC must agree and initiate the transfer requested by the beneficiary⁵¹. The issuer making payment for the transfer pursuant

46 Article 5.01 ISP98 ; Under UCP 600 Art. 16, the notice of discrepancy (notice of dishonor in ISP98) must be given before the close of the fifth banking day after the day of presentation.

47 Article 5.03 ISP98

48 Article 5.05 ISP98

49 Article 5.09 ISP98

50 Conversely, the UCP 600 does not permit standby LCs to "be transferred more than once, but partial transfers are allowed, and the UCP does not expressly permit an issuer to establish conditions" (Scranton, 2007, p. 128)

51 Article 6.03 ISP98

to the standby LC has the right to be reimbursed as if it had made payment to the beneficiary⁵².

Since a standby LC may be transferred, the beneficiary may also assign the proceeds⁵³. The issuer is not obligated to give effect to an assignment that it has not acknowledged⁵⁴. In regard to a standby LC, the bank's acknowledged assignment of proceeds only confers the assignee the right to demand payment of its assigned proceeds (Sifri, 2008, p. 106). The rights of the assignee depend on "the existence of any net proceeds payable to the beneficiary by the person making the acknowledgement, the rights of nominated persons and transferee beneficiaries, the rights of other acknowledged assignees, and any other rights of interests that may have priority under applicable law⁵⁵ (International Commerce Chamber, 1998). The acknowledgement can be conditioned on receipt of several documents⁵⁶. When there are conflicting claims to proceeds, payment to an acknowledged assignee may be suspended until the conflict is resolved⁵⁷. When the issuer pays an assignee, it is entitled to reimbursement of the payment as if it was made to the beneficiary.

ISP98 Rule 7 addresses the cancellation of a standby LC. The beneficiary's rights emerging

from a standby LC may not be cancelled, unless he/she approves it. His/her consent must be evidenced in writing or by any other action in a manner that implies that the beneficiary consents to cancellation. The cancellation becomes irrevocable after it has been communicated to the issuer. Before acceding to a beneficiary's authorization to cancel a standby, issuers may require reasonable measures such as reviewing the original standby, verifying the signature of the person signing for the beneficiary, a legal opinion, etc.⁵⁸.

ISP98 Rule 8 handles reimbursement obligations. Where settlement is made on behalf of a compliance presentation, the following persons have the obligation to reimburse:

- i. The applicant to the issuer requested to issue the standby;
- ii. The issuer to a person nominated to honor or otherwise give value⁵⁹.

The applicant must indemnify the issuer against any legal claims regarding the standby applicable law, fraud or illegal action of others or the issuer's performance of the confirmer's obligation that wrongfully dishonors a confirmation⁶⁰.

ISP98 Rule 9 regulates the length of time a standby LC is valid. A standby must contain an expiration date or permit the issuer to termina-

52 Article 6.05 ISP98

53 Article 6.06 ISP98

54 Article 6.07 ISP98

55 Article 6.07.b. ISP98

56 Article 6.08 ISP98

57 Article 6.09 ISP98

58 Article 7.02 ISP98

59 Article 8.01 IPS98

60 Article 8.01.b. ISP98

te the standby upon reasonable prior notice or payment⁶¹. The rights of a nominated person are not affected by the expiration of the standby. The clock begins to run on the first business day following the business day when the action could have been undertaken at the place where the action should have been undertaken⁶². “Retention of the original standby does not preserve any rights under the standby after the right to demand payment ceases⁶³” (International Commerce Chamber, 1998).

ISP98 Rule 10 deals with syndication and participation. If a standby has more than one issuer, and does not specify to whom it must be presented, the presentation may be done to any of the issuers with binding effects on all issuers⁶⁴. The issuer may sell its rights against the applicant and any presenter and may reveal relevant information of the applicant in confidence to potential participants⁶⁵. The sale of participation does not affect the issuer’s obligations to the standby, and does not create obligations between the participants and the beneficiary.

D. National Regulation

In order to determine the applicable law in the Colombian legal system, it is necessary to define the nature of a standby LC. A standby LC’s gene-

ral function is to serve as a means of payment wherein the seller seeks payment as soon as possible. A traditional LC serves as a payment instrument or source of financing for international commerce operations. However, a standby LC maintains its nature as a letter of credit and thus serves as a settlement guarantee of obligations, not as a means of payment (Superintendencia Financiera, 1999).

Therefore, standby and traditional LCs are classified as documentary credits, defined by Code of Commerce Art. 1408 as “the agreement through which, by request and according to the client’s instructions, the bank commits directly or through a correspondent bank to pay a determined amount of money to a beneficiary, or to pay, accept or negotiate bills of exchange issued by the beneficiary, effective with the submission of the agreed documentation and following the terms and conditions established” (Superintendencia Financiera, 1999). In this regard, the legal nature of a standby LC is one of a personal bail bond, classified as a suretyship⁶⁶, which, according to Colombia’s Civil Code Art. 2361, is defined as an accessory obligation, under which one or more persons assume a third person duty, committing to fulfill such a duty in case the main debtor defaults. In other words the standby LC is a type of personal guarantee (Superintendencia Financiera, 1994).

Now that the legal nature of a standby LC has been defined, it is important to establish the applicable law. As a letter of credit, a standby LC

61 Article 9.01 ISP98

62 Article 9.03 ISP98

63 Article 9.05 ISP98

64 Article 10.01 ISP98

65 Article 10.02.a. ISP98

66 The Spanish legal term is *fianza*.

is regulated by CC Art. 1408 and as a security, it is governed by Art. 2361 of Colombia's Civil Code. Since these norms fail to provide detailed regulation for a standby LC, contractual and customary rules that incorporate international regulations, such as the UCP 600 and the ISP98, have filled the regulatory gap (Superintendencia Financiera, 1999). The Financial Superintendence 007 Basic Legal Circular of 1996 also governs standby LCs⁶⁷.

Financial entities in Colombia need legal authorization to grant standby LCs and develop similar activities. Art. 7(g) and Art. 12(e) of Decree 923 (Colombia's Financial System Organic Statute) of April 2, 1997 legally authorizes banks and financial corporations, respectively, to issue LCs in furtherance of their main corporate purpose. Decree 923 Art. 1 authorizes banks and financial corporations that are legally capable of issuing traditional LCs to also issue standby LCs (Superintendencia Financiera, 1999).

Now that we have a clear understanding of Colombia's laws surrounding standby LCs, I shall analyze the specific regulations on the matter beginning with the Code of Commerce.

E. Code of Commerce

A documentary credit is defined as "an agreement through which, by request and according to the client's instructions, the bank commits directly or through a correspondent bank to pay

a determined amount of money to a beneficiary, or to pay, accept or negotiate bills of exchange issued by the beneficiary, effective with the submission of the accorded documentation and following the terms and conditions established⁶⁸".

Letters of credit, as documentary credit, must contain⁶⁹:

- i. The name of the issuer bank and the correspondent bank, where applicable;
- ii. The applicant's name;
- iii. The beneficiary's name;
- iv. The maximum amount of money that must be settled, or the amount that can be issued as letters of exchange on charge of the issuer or the seconding bank;
- v. The credit expiration date; and
- vi. The documents and requisites required by the presentation or accreditation in order for the credit to take effect.

The documentary credit can be revocable or irrevocable. As a general rule, the credit is revocable, unless the letter of credit provides otherwise⁷⁰. The issuer bank can revoke the credit at any time, as long as the beneficiary has not used it⁷¹.

67 Title II, Chapter I, paragraph 6

68 Article 1408 Code of Commerce

69 Article 1409 Code of Commerce

70 Article 1410 Code of Commerce

71 Article 1411 Code of Commerce

These rules are substantially different from the ISP98 rules, which provide that standby LCs are, as a general rule, irrevocable, unless the letter of credit provides otherwise. Under the Code of Commerce rules, a bank may revoke the credit, but under the ISP98, such revocation is prohibited. An irrevocable letter of credit must always state the expiration date. If the letter of credit is irrevocable and there is no expiration date, then the letter of credit will expire will six months from the date the bank notifies the credit beneficiary that the credit is effective⁷².

If authorized, a letter of credit is transferable and may be transferred in fractions, unless expressly prohibited, until the account has been satisfied. It may also be used to make partial payments when expressly authorized⁷³. This provision does not conflict with the ISP98 regulations, which state that standby LCs are generally non-transferable, but can be transferred if the standby so states. In order to comply with the national regulations, ISP98 also expressly prohibits the transfer of portions of the standby beneficiary rights.

In regard to bank liability, the intervention of a bank that is not the issuer to advise the beneficiary of a credit issuance does not make that intervening bank a seconding bank, unless it is obligated to pay the credit. In this case, the confirming bank will become responsible to the

beneficiary under the same terms as the issuer from the date of the confirmation⁷⁴. This provision complies with the ISP98, which also regulates the obligations of persons or entities besides the issuer (e.g. banks nominated by the issuer bank, confirmers, etc.).

All LCs are independent of the contract under which the open credit must be applied. Hence, neither the issuer bank nor the correspondent bank will acquire any obligation in regard to the form, sufficiency, accuracy, authenticity, fraud or legal effect of any document regarding such contract⁷⁵. This independence principle is the pillar of the standby LC under the ISP98 regulations.

F. Civil Code

Colombia's Financial Superintendence classifies the standby LC as a suretyship (*fianza*), thus Colombia's Civil Code applies. However, this classification is inappropriate as a suretyship is a security that is an accessory to the main obligation and a standby LC is an independent guarantee. This technical error makes the Civil Code provisions and the ISP98 regulations antithetical and therefore difficult to apply. Under the Civil Code, a suretyship (*fianza*) is an accessory obligation under which one or more persons are liable for a third person obligation that agrees with the creditor to fully or partially fulfill the obligation should the principal debtor breach. A su-

72 Article 1412 Code of Commerce

73 Article 1413 Code of Commerce

74 Article 1414 Code of Commerce

75 Article 1415 Code of Commerce

retyship may be granted in favor of the principal or a co-debtor⁷⁶.

Standby letters of credit are substantially different from suretyships. There are a number of differences between Civil Code provisions on suretyships and standby LCs, which are regulated by uniform international regulations. The most radical difference lies in the relationship between the guarantee and the main obligation. A suretyship is an accessory to the main obligation, thus its existence depends of the outcome of the main obligation. Conversely, the standby LC (equivalent to an independent guarantee in civil law) is independent from the main obligation and thus its existence has no relation to the main obligation.

A second major difference lies in the revocability of each instrument. In a suretyship the guarantor may revoke its guarantee as long as the principle obligation does not exist. Standby LCs are irrevocable, thus allowing the issuer to revoke a standby would contradict the nature of the instrument⁷⁷.

A third difference lies in limitations that severely impair the application of the standby LC in Colombia. In a suretyship the guarantor's obligation cannot exceed the original debtor's obligation⁷⁸ and if it does, it must be reduced under

the same terms of the main obligation⁷⁹. This clearly jeopardizes the usage of standby LCs in Colombia because the value of the standby LCs may be greater than the main obligation it guarantees. Likewise, when a third person action is guaranteed, only the compensation that arises from the breaching of the obligation by the third party is guaranteed⁸⁰. This excludes the major subjects a standby letter of credit can guarantee, such as the parties' ability to determine the standby LC's value.

A fourth difference is the method by which the guarantor may avoid payment. The guarantor in a suretyship may argue willful misconduct, violence or *res judicata* in an effort to avoid payment⁸¹. In standby LCs, the only admissible exception to payment to a creditor is document fraud. Suretyships also benefit from *excussio*, which allows the guarantor to demand that the creditor exhaust every remedy against the principal debtor before proceeding against the surety⁸². In standby LCs, it is the issuer who cannot require the beneficiary to go after the applicant's equity. In fact, the only requirement with which the beneficiary must comply is the presentation of the documents provided in the standby.

The fifth major difference involves expiration of the instrument. The suretyship, as an accessory obligation, will expire if the main obligation expi-

76 Art. 2361ve gs of Credit: aera y?Article 2361 Civil Code

77 Article 2365 Civil Code

78 Article 2369 Civil Code

79 Article 2370 Civil Code

80 Article 2369 Civil Code

81 Article 2380 Civil Code

82 Article 2383 Civil Code

res⁸³. However, the standby LC, as an independent obligation, remains valid even if the guaranteed obligation expires.

The final major difference involves the insolvency of the guarantor. In this respect, suretyship rules that apply to the standby LC applicant, issuer and beneficiary contradict uniform international standby LC rules. For example, suretyship rules state that when the guarantor is insolvent the debtor must provide a new suretyship⁸⁴. Uniform international rules for standby LCs, on the other hand, provide that one party's insolvency shall not affect the rights and obligations of the other parties.

In conclusion, there are substantial differences in the provisions contained in Colombia's national laws and the international regulations governing the standby LC. These multiple differences between suretyships and standby LCs mean that both regulations cannot be applied simultaneously.

These differences affect businesses in the everyday practice. For example, in a transaction between two Colombian companies, where the issuing bank is also Colombian, and the business will be executed in Colombia, the issuing bank will refuse to issue the standby LC with an incorporated international regulation (such as the UCP 600), on the basis that they supersede public policy rules from the Civil Code, regarding suretyships.

83 Article 2406. 3. Civil Code

84 Article 2375 Civil Code

G. Financial Superintendence 007 Basic Legal Circular of 1996

This regulation explains the characteristics of documentary credits according to the Code of Commerce. It first argues that letters of credit are not equivalent to the mandated contract⁸⁵. Then, it sets forth the main characteristics of the documentary credit, such as the autonomy of the relationships between each party in a letter of credit, the obligations written a letter of credit, and the literal nature of a letter of credit, which refers to the presentation of the documents in order for a letter of credit to become operative⁸⁶.

H. Standby LCs in Government Contracts

The standby LC plays a vital role in employment contracts between government contractors and the Colombian government. For example, when the government contracts with a private company to construct an infrastructure project, a standby LC guarantees the risks associated with the project. In order to cover these risks and to ensure that private government contractors fulfill their contract obligations, the Colombian government has issued three decrees in the past seven years, each of which has been repealed and replaced by a new decree regulating the use of banking guarantees, such as the standby LC, in government contracts. The legislative history of these decrees begins with Decree 4829

85 Article 6.1, Title II, Chapter 1, Financial Superintendence 007 Basic Legal Circular of 1996

86 Article 6.2, Title II, Chapter 1, Financial Superintendence 007 Basic Legal Circular of 1996

of 2008, which included the standby LC as one guarantee available for use in government contracts. Under this decree, the issuer bank, per the contractor's instructions, could irrevocably guarantee payment of its contract obligations. The issuer bank would disburse this payment after receiving the standby LC, together with the duly enforceable administrative act demonstrating the contractor's default. Under Decree 4829 of 2008, standby LCs had to include a stipulation allowing international regulations such as the ICC Uniform Customs and Practice for Documentary Credits to govern general contracting conditions, but such provisions could not contradict the Code of Commerce provisions on Documentary Credits. This is a clear example of the incorporation of uniform international regulations into standby LCs in Colombia.

Decree 734 of 2012 repealed Decree 4829 of 2008 but maintained exactly the same requirements of incorporating the ICC Uniform Customs and Practice for Documentary Credits into the standby LC. A year later, Decree 734 was repealed by Decree 1510. In this new decree, which is in force today, the standby LC continues to be an eligible guarantee for government contracts. However, this latest decree has removed the incorporation requirement of any uniform international regulation into the standby LC. Decree 1510 doesn't define the standby LC, it just provides that it is an admissible guarantee. That said, it is clear that standby LCs in government contracts have been recognized as independent, on first demand, bank guarantees that include the use of uniform international regulations. Therefore, despite the removal of such international

regulations, it is evident that Colombia's legislative and executive powers intended to regulate standby LCs by applying uniform international regulations rather than issuing national regulations on the matter.

Even though the government contracting regime is only applicable to contracts where one or more of the parties is a public entity, this is a clear intention of Colombia's administration and its legislative body to directly apply uniform international regulations. To that extent, these decrees recognized that the Code of Commerce applies to standby LCs, especially to the rules that address Documentary Credits, but not to the provisions that address suretyships, as suretyship provisions are not applicable to the standby LC.

I. Lack of regulation

Since Decree 1510 fails to define or regulate the standby LC, no specific regulation governs the standby LC in Colombia. All the provisions mentioned above regulate letters of credit, documentary credit, or suretyships, which are substantially different. As a result of this legal gap, parties engaging in transactions guaranteed by standby LCs must incorporate uniform international regulations, such as the ISP98 or the UCP 600, into their obligations under the standby LC. If parties had to limit their contracting intent to the national legal system they would face the legal insecurity of this vacuum and be forced to fill this gap with doctrine from the Financial Superintendence, which is contradictory in definition and applicable law of the standby LC.

It is more appropriate to incorporate uniform international regulations that are issued by experts in international business who better understand the standby LC, than to limit contractors to Colombia's contradictory laws. This practice has been accepted in several arbitral awards (*Laudo Arbitral Cadenalco S.A. vs. Corfinura S.A.*, 1999).

The autonomy of the parties in the commercial context is important as it provides them with the power to regulate their own agreements. According to Professor Fernando Hinestrosa, "this autonomy is limited, however, as the parties' actions must adhere to the legal system of the country in which they are working and comply with public policy rules, acknowledged as political diktats that strictly yield the private activity to the general interest, taking into account what would be best for the community" (Hinestrosa, 1986). Article 4 of the Code of Commerce provides that party agreements based on public policy take precedence over any business customs and practices and any default rules that regulate any issues, which the parties did not expressly agree upon. Therefore, business relationships are first subject to public policy rules and the laws of the country in which they are working, then to their own party agreements, and finally to default and customary rules.

In addition to limiting the autonomy of parties in the commercial context, public policy rules can impose sanctions or establish regulations that are not susceptible to modifications or derogations by private agreements. While default rules seek only to protect the party's interests, (Nar-

váez García, 2002, p. 109), parties must always attempt to comply with public policy rules, which inspire principles closely related to the notion of public order based on the ideals of national security, public morality and third party protection. Public policy rules are determined by whether they violate these three principles. Hence, it must be determined on a case-by-case basis whether the parties' agreements undermine public policy. Based on my research, I conclude that there are no public policy rules in Colombia that regulate standby LCs and therefore uniform international regulations can supersede standby LCs via party agreements.

J. Guidelines

The following principles guide the applicable law for standby letters of credit in the Colombian legal system:

- i. Documentary credit provisions from the Code of Commerce govern standby letters of credit in Colombia's domestic laws and regulations. They are also governed by suretyship (*fianza*) norms under Colombia's Civil Code. Standby LCs are guided by documentary credit regulations in the Financial Superintendence 007 Basic Legal Circular of 1996 and Decree 1510 of 2013 governs standby LCs where a government contract is involved.
- ii. International rules of practice apply to a standby LC only if the instrument expressly provides that it is governed by one or more international rules of practice, such as the ISP98 or the UCP 600.

K. Assessment

The following assessment should be undertaken when a discrepancy between a domestic law and an international rule of practice arises:

- i. Determine the degree of the national provision. Is it public policy? Does it include otherwise agreed upon clauses?
- ii. If it includes such clauses, then the international rule of practice will be considered an otherwise agreed upon clause and incorporated into the standby LC and will prevail over the domestic law.
- iii. If the national provision is a public policy rule, it does not admit otherwise agreed upon clauses; hence, the national law will prevail over the international rule of practice.

III. CONCLUSIONS

The following conclusions were obtained as a result of this research:

1. The Financial Superintendence misunderstood the nature of the standby LC, when it categorized it as a suretyship (*fianza*) because a historical and methodological approach shows that a suretyship is an independent guarantee, which is the opposite of a standby LC.
2. This error may seriously impair the use of standby LCs in Colombia's legal system, because contradictions between public policy rules under the Civil Code involving suretyships and

international rules of practice regarding standby LCs could result in the practical inoperativeness of this instrument.

3. Apart from the national rules governing suretyships, national rules that govern standby LCs do not pose a threat to its application in Colombia.
4. National rules involving standby LCs are not public policy rules and therefore can be superseded by uniform international regulations, which the parties may incorporate into the standby LC's text.
5. The administrative and legislative powers involved in Colombia's government contracting regime provided the need to incorporate uniform international regulations into standby LCs. They also recognized that the applicable law to this instrument is the Code of Commerce's provisions on documentary credit, rather than the Colombian Civil Code's provisions on suretyships.

Nevertheless, the Financial Superintendence's concepts, if strictly followed, still pose a threat to the use of standby LCs in Colombia. The following solutions are proposed in order to prevent this threat:

1. The Financial Superintendence should issue an advisory opinion clarifying the nature of standby LCs. In this clarification, it should separate this instrument from the suretyship, and explain how it is, in fact, an independent guarantee. This will help clarify any misunderstanding.
2. The Financial Superintendence should issue an advisory opinion clarifying that, although

standby LCs and suretyship have some commonalities, standby LC provisions are not regulated by public policy, and therefore they can include otherwise agreed upon clauses. Although this solution is incorrect from a conceptual standpoint, it will prevent the operative threats posed by the suretyship rules.

3. The classification made by the Financial Superintendence should be disregarded and the interpretation given in this text should be applied. This will allow the parties to supersede the default national rules and use uniform international regulations.

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