# TITLE I

# OBLIGATIONS

*(Arts. 1156-1304.)*

## Chapter I

## GENERAL PROVISIONS

**ARTICLE 1156. An obligation is a juridical necessity to give, to do or not to do. (n)**

### Meaning of obligation.

The term *obligation* is derived from the Latin word *"obligatio"* which means a "tying" or "binding."

(1) It is a tie of law or a juridical bond by virtue of which one is bound in favor of another to render something — and this may consist in giving a thing, doing a certain act, or not doing a certain act.

(2) Manresa defines the term as "a legal relation established between one party and another, whereby the latter is bound to the fulfillment of a prestation which the former may demand of him." (8 Manresa 13.)

(3) Article 1156 gives the Civil Code definition of obligation, in its passive aspect. Our law merely stresses the duty of the debtor or obligor (he who has the duty of giving, doing, or not doing) when it speaks of obligation as a juridical necessity.

### Meaning of juridical necessity.

Obligation is a *juridical necessity* because in case of non-compliance, the courts of justice may be called upon to enforce its fulfillment or, in default thereof, the economic value that it represents. In a proper case,

the debtor may also be made liable for *damages,* which represent the sum of money given as a compensation for the injury or harm suffered by the creditor or obligee (he who has the right to the performance of the obligation) for the violation of his rights.

In other words, the debtor must comply with his obligation whether he likes it or not; otherwise, his failure will be visited with some harmful or undesirable legal consequences. If obligations were not made enforceable, then people can disregard them with impunity. If an obligation cannot be enforced, it may be only a natural obligation.

### Nature of obligations under the Civil Code.

Obligations which give to the creditor or obligee a right of action in courts of justice to enforce their performance are known as *civil obligations.* They are to be distinguished from *natural obligations* which, not being based on positive law but on equity and natural law, do not grant a right of action to enforce their performance although in case of voluntary fulfillment by the debtor, the latter may not recover what has been delivered or rendered by reason thereof. (Art.* 1423.)

Natural obligations are discussed under the Title dealing with "Natural Obligations." (Title III, Arts. 1423-1430.)

### Essential requisites of an obligation.

An obligation as defined in Article 1156 is constituted upon the concurrence of the four (4) essential elements thereof, namely:

(1) A *passive subject* (called debtor or obligor) or the person who is bound to the fulfillment of the obligation; he who has a duty;

(2) An *active subject* (called creditor or obligee) or the person who is entitled to demand the fulfillment of the obligation; he who has a right;

(3) *Object* or *prestation* (subject matter of the obligation) or the conduct required to be observed by the debtor. It may consist in giving, doing, or not doing. (see Art. 1232.) Without the prestation, there is nothing to perform. In bilateral obligations (see Art. 1191.), the parties are reciprocally debtors and creditors; and

*Unless otherwise indicated, refers to article in the Civil Code.

(4) A *juridical* or *legal tie* (also called efficient cause) or that which binds or connects the parties to the obligation. The tie in an obligation can easily be determined by knowing the source of the obligation. (Art. 1157.)

EXAMPLE:

Under a building contract, X bound himself to construct a house for Y for P1,000,000.00.

Here, X is the passive subject, Y is the active subject, the building of the house is the object or prestation, and the agreement or contract, which is the source of the obligation, is the juridical tie.

Suppose X had already constructed the house and it was the agreement that Y would pay X after the construction is finished. X, then, becomes the active subject and Y, the passive subject.

**Form of obligation.**

(1) As a general rule, the law does not require any form in obligations arising from contracts for their validity or binding force. (see Art. 1356.)

(2) Obligations arising from other sources (Art. 1157.) do not have any form at all.

**Obligation, right, and wrong (cause of action) distinguished.**

(1) *Obligation* is the act or performance which the law will enforce.

(2) *Right,* on the other hand, is the power which a person has under the law, to demand from another any prestation.

(3) A *wrong* (cause of action), according to its legal meaning, is an act or omission of one party in violation of the legal right or rights of another, causing injury to the latter;[1]

[1]In a breach of contract, the contract violated is the subject matter, while the breach thereof by the obligor is the cause of action. The subject matter is the item with respect to which the controversy has arisen or concerning which the wrong has been done, and is ordinarily the right, the thing or the contract under dispute. (Bachrach Corporation vs. Court of Appeals, 296 SCRA 487 [1998]; Dela Rosa vs. Mendiola, 401 SCRA 704 [2003].)

**Essential elements of cause of action.**

(1) Its essential elements are:

(a) a legal right in favor of a person (creditor/plaintiff) by whatever means and under whatever law it arises or is created;

(b) a correlative legal obligation on the part of another (debtor/defendant) to respect or not to violate said right; and

(c) an act or omission in breach or violation of said right by the defendant with consequential injury or damage to the plaintiff for which he may maintain an action for the recovery of damages or other appropriate relief. (see Ma-ao Sugar Central Co. vs. Barrios, 79 Phil. 66 [1948]; Teves vs. People's Homesite and Housing Corp., 23 SCRA 1141 [1968]; Development Bank of the Phils. vs. Pundogar, 218 SCRA 118 [1993]; Parañaque King Enterprises vs. Court of Appeals, 269 SCRA 727 [1997]; Nadela vs. City of Cebu, 411 SCRA 315 [2003].)

(2) If any of these elements is absent, the complaint becomes vulnerable to a motion to dismiss on the ground of failure to state a cause of action. (San Lorenzo Village Assoc., Inc. vs. Court of Appeals, 288 SCRA 115 [1998]; Uy vs. Evangelista, 361 SCRA 95 [2001].) The presence of a cause of action rests on the sufficiency, and not on the veracity, of the allegations in the complaint, which will have to be examined during the trial on the merits. (Pioneer International, Ltd. vs. Guadiz, Jr., 535 SCRA 584 [2007].) The test is whether the material allegations of the complaint, assuming to be true, state ultimate facts which constitutes plaintiff's cause of action such that plaintiff is entitled to a favorable judgment as a matter of law. (Rovels Enterprises, Inc. vs. Ocampo, 391 SCRA 176 [2002].)

(3) A cause of action only arises when the last element occurs, *i.e.*, at the moment a right has been transgressed.

(a) It is to be distinguished from *right of action* or the right to commence and maintain an action, in that the former is governed by the procedural law while the latter depends on substantive law. The right of action springs from the cause of action, but does not accrue until all the facts which constitute the cause of action have occurred. (Multi-Realty Dev. Corp. vs. Makati Tuscany Condominium Corp., 491 SCRA 9 [2006]; Borbe vs. Calalo, 535 SCRA 89 [2007].) The action shall be brought in the name of the party who by law is entitled to the right to be enforced.

(b) An obligation on the part of a person cannot exist without a corresponding right existing in favor of another, and *vice-versa*, for every right enjoyed by a person, there is a corresponding obligation on the part of another to respect such right.

ILLUSTRATIVE CASE:

*S rejected or cancelled a contract to sell his property even before the arrival of the period in the exercise of the option to buy by the purchaser who has already made a downpayment.*

*Facts:* S and B entered into a contract to sell, whereby B, after making a downpayment, was given the option to pay the balance of the purchase price of a parcel of land. Later, S "rejected the contract to sell" even before the arrival of the period for the exercise of said option on the ground that the terms and conditions of the contract are grossly disadvantageous and highly prejudicial to his interest. S sent two (2) checks to B in an apparent effort to return the downpayment.

S contends that the complaint was prematurely filed because at the time of the institution of the complaint, B has yet to exercise his option under the "Option of Buyer" clause of the contract.

*Issue:* Has B a cause of action against S for prematurity?

*Held:* Yes. (1) *All the elements of a cause of action are present. — First*, there is a legal right in favor of B, *i.e.*, the right to complete the payment of the purchase price should he choose to do so; there is an obligation on the part of S to sell the subject property exclusively to B upon full payment of the purchase price; and there was a breach of S's obligation to sell the property, when S rejected the contract to sell even before B could exercise his option to buy notwithstanding that he had already made a downpayment.

(2) *S rejected contract to sell in no uncertain terms.* — The fact that the rejection or cancellation of the contract by S was not made judicially or by notarial act (see Art. 1592.) is of no moment. It is enough for purposes of determining the existence of a cause of action that S has declared in no uncertain terms his refusal to be bound by the contract to sell. Such declaration, coupled with S's act of returning B's down payment, clearly indicates S's rejection of the contract to sell. *(Leberman Realty Corporation vs. Typingco, 293 SCRA 316 [1998].)*

### Cause of action based upon a written contract.

Actions based upon a written contract should be brought within 10 years from the time the right of action accrues. (Art. 1144.) The accrual

refers to the cause of action. Accordingly, an action based on a contract accrues only when an actual breach or violation thereof occurs. (China Banking Corp. vs. Court of Appeals, 461 SCRA 162 [2005]; see Art. 1169.) Therefore, the period of prescription commences, not from the date of execution of the contract but from the occurrence of the breach.

The cause of action resulting from breach of contract is dependent on the facts of each particular case. (Pilipinas Shell Petroleum Corporation vs. John Bordman Ltd., 473 SCRA 151 [2006].)

(1) In an action to rescind a *contract of sale on installment basis*, for non-payment, the cause of action arises at the time the last installment is not paid. (Nabus vs. Court of Appeals, 193 SCRA 732 [1991].)

(2) Where an overdraft agreement stipulates that the *obligation is payable on demand,* the breach starts only when demand is made. (Elido vs. Court of Appeals, 216 SCRA 637 [1992]; China Banking Corporation vs. Court of Appeals, *supra*.)

(3) In a *contract of loan with real estate mortgag*e, whereby the creditor could unilaterally increase the interest rate, where the creditor foreclosed the mortgage when the debtor failed to pay the loan, the cause of action for the annulment of the foreclosure sale should be counted from the date the debtor discovered the increased interest rate (Banco Filipino Savings & Mortgage Bank vs. Court of Appeals, 388 Phil. 27, 332 SCRA 241 [2000].)

(4) Where the *agreement to buy and sell was conditioned upon the conduct of a preliminary survey* of the land to verify, whether it contained the area stated in the tax declaration, the right of action for specific performance arose only when the plaintiff discovered the completion of the survey. (Cole vs. Gregorio, 202 Phil. 226, 116 SCRA 670 [1982].)

(5) With respect to *money claims arising from a contract of employment*, which would prescribe in three (3) years from the time the cause of action accrued, the cause of action would arise from the date the employer made a definite denial of the employee's claim, for prior to such denial, it is deemed that the issues had not yet been joined because the employee could have still been reinstated (Serrano vs. Court of Appeals, 415 Phil. 447, 363 SCRA 223 [2001].)

(6) In an action for *reformation of a contract,* where the plaintiff alleged, among others, that the contract was one-sided in favor of

the defendant, and that certain events had made the arrangement inequitable, the cause of action for reformation would arise only when the contract appeared disadvantageous. (Naga Telephone Co. vs. Court of Appeals, 230 SCRA 351 [1994].)

(7) The *nature of the product sold* is a major factor in determining when the cause of action has accrued. For example, when fuel oil is delivered in drums, a buyer readily assumes that the agreed volume *can be* and *actually* is, contained in those drums. He is not expected to make a meticulous measurement of each and every delivery. In case of short deliveries, the cause of action will arise only from the discovery of the same with certainty. (Pilipinas Shell Petroleum Corporation vs. John Bordment, Ltd., *supra*.)

**Injury, damage, and damages distinguished.**

The words "injury," "damage," and "damages" are sometimes used synonymously, although there is a material difference among them.

(1) Injury is the illegal invasion of a legal right; it is the wrongful act or omission which causes loss or harm to another, while damage is the loss, hurt, or harm which results from the injury. On the other hand, damages denote the sum of money recoverable as amends for the wrongful act or omission; and

(2) Injury is the legal wrong to be redressed, while damages are the recompense or compensation awarded or recoverable for the damage or loss suffered. (Custodio vs. Court of Appeals, 253 SCRA 483 [1996].)

**Existence of one without the other.**

There may be injury without damage and damage without injury.

(1) *Proof of loss for injury.* — A wrongful violation of his legal right is not sufficient to entitle a person to sue another in a court of justice for the enforcement or protection of said right. As a rule, there must be, in addition, loss or damage caused to him by the violation of his right. But except for actual or compensatory damages (Art. 2199.), no pecuniary proof is necessary in order that moral, nominal, temperate, liquidated, or exemplary damages may be awarded. (Art. 2216.)

(2) *Liability for damages of a person for exercising his legal rights.* — A person has the right to take all legal steps to enforce his legal and/or equitable rights. One who makes use of his legal right does no injury. *Qui jure suo utitur mullum damnum facit.* If damage results from a person's exercising his legal rights, it is *damnum absque injuria* (damage without injury). (Auyong Hian vs. Court of Appeals, 59 SCRA 110 [1974].) The plaintiff must establish that the damage to him resulted from a breach or violation of legal duty which the defendant owned to him; otherwise, the consequences must be borne by the plaintiff alone.

In other words, in order that the law will give redress for an act (or omission) causing damage, that act must be not only hurtful, but wrongful.[2] (Custodio vs. Court of Appeals, *supra;* see Philippine National Bank vs. Court of Appeals, 367 SCRA 198 [2001].)

ILLUSTRATIVE CASE:

*Acts of importer contesting forfeiture, delay in the delivery of goods to highest bidder.*

*Facts:* X imported certain goods. The Collector of Customs declared the goods forfeited in favor of the government and ordered the sale thereof at public auction. The bid of Y was approved and the goods were awarded to him.

Under the law, X has the right to have the decision of the Collector of Customs reviewed by the Commissioner of Customs, and from the decision of the latter, to appeal to the Court of Tax Appeals (Secs. 2313, 402, Tariff and Customs Code.), and from the latter's decision, to the Supreme Court. X will be prejudiced if the sale is not set aside. (see Art. 1397.)

*Issue:* Is X liable to Y for damages from the consequent delay in the delivery of the goods?

*Held:* Such delay is an incident to the exercise by X of his right to contest the forfeiture and the sale of his goods. *(see Auyong Hian vs. Court of Appeals, supra.)*

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[2]Art. 19. Every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith.

The principle of *damnum absque injuria* does not apply when there is an abuse of a person's right. Article 19 prescribes a "primordial limitation on all rights" by setting certain standards that must be observed in the exercise thereof. It does not permit an abuse of rights which is committed when the defendant acts with bad faith or intent to prejudice the plaintiff in the exercise of a right. Such abuse will give rise to liability for damages. Good faith, however, is presumed.

### Kinds of obligation according to subject matter.

From the viewpoint of the subject matter, obligation may either be:

(1) *Real obligation* (obligation to give) or that in which the subject matter is a thing which the obligor must deliver to the obligee; or

(2) *Personal obligation* (obligation to do or not to do) or that in which the subject matter is an act to be done or not to be done.

There are thus two (2) kinds of personal obligation:

(a) *Positive personal obligation* or obligation to do or to render service (see Art. 1167.); and

(b) *Negative personal obligation* or obligation not to do (which naturally includes obligations "not to give"). (see Art. 1168.)

**ART. 1157. Obligations arise from:**

**(1) Law;**

**(2) Contracts;**

**(3) Quasi-contracts;**

**(4) Acts or omissions punished by law; and**

**(5) Quasi-delicts. (1089a)**

### Sources of obligations.

An obligation imposed on a person and the corresponding right granted to another must be rooted in at least any of the following sources:

(1) *Law.* — when they are imposed by the law itself, *e.g.*, obligation to pay taxes; obligation to support one's family (see Art. 195, Family Code.);

(2) *Contracts.* — when they arise from the stipulation of the parties (Art. 1306.), *e.g.*, the obligation to repay a loan by virtue of an agreement;

(3) *Quasi-contracts.* — when they arise from lawful, voluntary and unilateral acts and which are enforceable to the end that no one shall be unjustly enriched or benefited at the expense of another (Art. 2142.), *e.g.*, the obligation to return money paid by mistake or which is not due. (Art. 2154.) In a sense, these obligations may be considered as arising from law;

(4) *Crimes or acts or omissions punished by law.* — when they arise from civil liability which is the consequence of a criminal offense (Art. 1161.), *e.g.,* the obligation of a thief to return the car stolen by him; the duty of a killer to indemnify the heirs of his victim; and

(5) *Quasi-delicts or torts.* — when they arise from damage caused to another through an act or omission, there being fault or negligence, but no contractual relation exists between the parties (Art. 2176.), *e.g.,* the obligation of the head of a family that lives in a building or a part thereof to answer for damages caused by things thrown or falling from the same (Art. 2193.); the obligation of the possessor of an animal to pay for the damage which it may have caused. (Art. 2183.)

The enumeration by the law is exclusive; hence, there is no obligation as defined in Article 1156, if its source is not any of those enumerated.[3]

**Sources classified.**

The law enumerates five (5) sources of obligations. They may be classified as follows:

(1) Those emanating from *law;* and

(2) Those emanating from *private acts* which may be further subdivided into:

(a) those arising from *licit acts,* in the case of contracts and quasi-contracts; and

(b) those arising from *illicit acts,* which may be either punishable by law in the case of delicts, or not punishable in the case of quasi-delicts.

Actually, there are only two (2) sources: law and contracts, because obligations arising from quasi-contracts, crimes, and quasi-delicts are

[3]The principle that no person may unjustly enrich himself at the expense of another is embodied in Article 22 of the Civil Code. This principle applies not only to substantive rights but also to procedural remedies. One condition for invoking this principle is that the aggrieved party has no other action based on contract, quasi-contract, crime, quasi-delict or any other provision of law. (Reyes vs. Lim, 408 SCRA 560 [2003]; A. Tolentino, Civil Code of the Philippines, 1990, pp. 77,82.) Article 22 provides: "Every person who through an act of performance by another, or any other means, acquires or comes into possession of something at the expense of the latter without just or legal ground, shall return the same to him."

A *practice* or *custom* is, as a general rule, not a source of a legally demandable or enforceable right. (Makati Stock Exchange, Inc. vs. Campos (585 SCRA 120 [2009].)

really imposed by law. (see Leung Ben vs. O'Brien, 38 Phil. 182 [1918].) Where the source of the obligation is a private act, the law merely recognizes or acknowledges the existence of the obligation.

ILLUSTRATIVE CASE:

*Liability of sheriff lawfully enforcing a judgment in an ejectment suit.*

*Facts:* A judgment was rendered by a justice of the peace court (now municipal court) in favor of X who brought an ejectment suit against Y, the owner of the house built on the land of X. Z, the deputy sheriff who executed the judgment, was obliged to remove the house of Y from the land according to the usual procedure in the action for ejectment.

*Issue:* Is Y entitled to indemnity arising from the destruction of his house?

*Held:* No proof has been submitted that a contract had been entered into between plaintiff (Y) and the defendants (X and Z) or that the latter had committed illegal acts or omissions or incurred in any kind of fault or negligence, from any of which an obligation might have arisen on the part of X and Z to indemnify Y. For this reason, the claim for indemnity, on account of acts performed by the sheriff, while enforcing a judgment, cannot under any consideration be sustained. *(Navales vs. Rias, 8 Phil. 508 [1907].)*

**ART. 1158. Obligations derived from law are not presumed. Only those expressly determined in this Code or in special laws are demandable, and shall be regulated by the precepts of the law which establishes them; and as to what has not been foreseen, by the provisions of this Book. (1090)**

## Legal obligations.

Article 1158 refers to legal obligations or obligations arising from law. They are not presumed because they are considered a burden upon the obligor. They are the exception, not the rule. To be demandable, they must be clearly set forth in the law, *i.e.*, the Civil Code or special laws. Thus:

(1) An employer has no obligation to furnish free legal assistance to his employees because no law requires this, and, therefore, an employee may not recover from his employer the amount he may have paid a lawyer hired by him to recover damages caused to said employee by a stranger or strangers while in the performance of his duties. (De la Cruz vs. Northern Theatrical Enterprises, 95 Phil. 739 [1954].)

(2) A private school has no legal obligation to provide clothing allowance to its teachers because there is no law which imposes this obligation upon schools. But a person who wins money in gambling has the duty to return his winnings to the loser. This obligation is provided by law. (Art. 2014.)

Under Article 1158, *special laws* refer to all other laws not contained in the Civil Code.

ILLUSTRATIVE CASES:

1. *Liability of husband for medical assistance rendered to his wife but contracted by his parents.*

*Facts:* X, by virtue of having been sent for by B and C, attended as physician and rendered professional services to a daughter-in-law of B and C during a difficult and laborious childbirth.

*Issue:* Who is bound to pay the bill: B and C, the parents-in-law of the patient, or the husband of the latter?

*Held:* The rendering of medical assistance in case of illness is comprised among the mutual obligations to which spouses are bound by way of mutual support.[4] If spouses are mutually bound to support each other, there can be no question that when either of them by reason of illness should be in need of medical assistance, the other is to render the unavoidable obligation to furnish the services of a physician and is liable for all expenses, including the fees for professional services.

This liability originates from the above-mentioned mutual obligation which the law has expressly established between the married couple. B and C not having personally bound themselves to pay are not liable. *(Pelayo vs. Lauron, 12 Phil. 453 [1909].)*

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2. *Title to property purchased by a person for his own benefit but paid by another.*

*Facts:* X, of legal age, bought two vessels from B, the purchase price thereof being paid by C, X's father. Subsequently, differences arose between X and C. The latter brought action to recover the vessels, he having paid the purchase price.

*Issue:* Is there any obligation on the part of X to transfer the ownership of the vessel to C?

*Held:* None. If any such obligation was ever created on the part of X, said obligation must arise from law. But obligations derived from law

[4]See Arts. 194, 195, Family Code.

are not presumed. Only those expressly determined in the Civil Code or in special laws are demandable. Whatever right C may have against X either for the recovery of the money paid or for damages, it is clear that such payment gave him no title, either legal or equitable, to these vessels. *(Martinez vs. Martinez, 1 Phil. 647 [1902].)*

*Note:* If X were a minor, the vessels would belong to C in ownership and usufruct under Article 161 of the old Civil Code. (now Art. 324.[5]) Under Article 1448,[6] the payment may give rise to a gift or an implied trust.

**ART. 1159. Obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith. (1091a)**

## Contractual obligations.

The above article speaks of contractual obligations or obligations arising from contracts or voluntary agreements.

A *contract* is a meeting of minds between two persons whereby one binds himself, with respect to the other, to give something or to render some service. (Art. 1305.) It is the formal expression by the parties of their rights and obligations they have agreed upon with respect to each other.

(1) *Binding force.* — Obligations arising from contracts are governed primarily by the agreement of the contracting parties. Once perfected, valid contracts have the force of law between the parties who are bound to comply therewith in good faith, and neither one may without the consent of the other, renege therefrom. (Tiu Peck vs. Court of Appeals, 221 SCRA 618 [1993].) In characterizing contracts as having the force of law between the parties, the law stresses the obligatory nature of a binding and valid agreement (William Golangco Construction Corporation vs. Phil. Commercial International Bank, 485 SCRA 293 [2006].), absent any allegation that it is contrary to law, morals, good customs, public order, or public policy. (Art. 1306.)

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[5]This provision is not contained in the Family Code.

[6]Art. 1448. There is an implied trust when property is sold, and the legal estate is granted to one party but the price is paid by another for the purpose of having the beneficial interest of the property. The former is the trustee, while the latter is the beneficiary. However, if the person to whom the title is conveyed is a child, legitimate or illegitimate, of the one paying the price of the sale, no trust is implied by law, it being disputably presumed that there is a gift in favor of the child.

(a) The law,[7] recognizing the obligatory force of contracts (Arts. 1139, 1308, 1315, 1356.), will not permit a party to be set free from liability for any kind of misperformance of the contractual undertaking or a contravention of the tenor thereof. (Art. 1170.) The mere proof of the existence of the contract and the failure of its compliance justify, *prima facie*, a corresponding right of relief.[8] (FGU Insurance Corp. vs. G.P. Sarmiento Trucking Corp., G.R. No. 141910, Aug. 6, 2002.)

(b) In law, whatever fairly puts a person on inquiry is sufficient notice, where the means of knowledge are at hand, which if pursued by proper inquiry, the full truth might have been ascertained. Thus, where a purchaser of a memorial lot, on installment basis, had full knowledge of the terms and conditions of the sale, including the rules and regulations issued by the seller governing the memorial park, to which she obliged herself to abide, cannot later feign ignorance of said rules. (Dio vs. St. Ferdinand Memorial Park, Inc., 509 SCRA 453 [2006].)

(c) If it occurs to one of the contracting parties to allege some defect in a contract as a reason for invalidating it, such alleged defect must be proved by him by convincing evidence since its validity or compliance cannot be left to will of one of them. (see Art. 1308.) "An experienced businessman who signs important legal papers cannot disclaim the consequent liabilities therefor after being a signatory thereon." (Blade International Marketing Corp. vs. Court of Appeals, 372 SCRA 333 [2001].) It behooves every contracting party to learn and to know the contents of an instrument before signing and agreeing to it. (Dio vs. St. Ferdinand Memorial Park, Inc., *supra*.)

(d) Courts have no alternative but to enforce contracts as they were agreed upon and written when the terms thereof are clear

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[7]The rule of *lex loci contractus* (the law of the place where the contract is made) governs in cases of Filipino workers whose employment contracts were approved by the Philippine Overseas Employment Administration (POEA) and were entered into and perfected in the Philippines. (Philippine Employment Services and Resources, Inc. vs. Paramo, 427 SCRA 732 [2004].)

[8]It has been consistently ruled that a bonus is not a demandable and enforceable obligation, unless the giving of such bonus has been the company's long and regular practice, *i.e.*, the giving of the bonus should have been done over a long period of time, and must be shown to have been consistent and deliberate. (Phil. Appliance Corp. vs. Court of Appeals, 430 SCRA 525 [2004].)

and leave no room for interpretation. (Art. 1370.). This does not mean, however, that contract is superior to the law. Although a contract is the law between the contracting parties, the provisions of positive law which regulate such contracts are deemed included and shall limit and govern the relations between the parties. (Asia World Recruitment, Inc. vs. National Labor Relations Commission, 313 SCRA 1 [1999].)

(e) A compromise agreement is immediately executory and not appealable, except for vices of consent (Art. 1330.) or forgery. Upon the parties, it has the effect and the authority of *res judicata*, once entired into. To have the force of law between the parties, it must comply with the requisites of contracts. (Art. 1318.) It may be either extrajudicial (to prevent litigation) or judicial (to end a litigation). (Magbanua vs. Uy, 458 SCRA 184 [2005].)

(2) *Requirements of a valid contract.* — As a source of obligation, a contract must be valid and enforceable. (see Art. 1403.) A contract is valid (assuming all the essential elements are present, Art. 1318.) if it is not contrary to law, morals, good customs, public order, *and* public policy. It is invalid or void if it is contrary to law, morals, good customs, public order, *or* public policy. (Art. 1306; see Phoenix Assurance Co., Ltd. vs. U.S. Lines, 22 SCRA 675 [1968].)

In the eyes of the law, a void contract does not exist. (Art. 1409.) Consequently, no obligations will arise.

(3) *Where contract requires approval by the government.* — Where a contract is required to be verified and approved by the government before it can take effect (*e.g.*, contract for overseas employment must be approved by the Philippine Overseas Employment Administration [POEA] under Art. 21[c] of the Labor Code), such contract becomes the law between the contracting parties only when approved, and where there is nothing in it which is contrary to law, etc., its validity must be sustained. (Intetrod Maritime, Inc. vs. National Labor Relations Commission, 198 SCRA 318 [1991].)

(4) *Compliance in good faith.* — It means compliance or performance in accordance with the stipulations or terms of the contract or agreement.[9] Good faith and fair dealing must be observed to prevent

[9]Art. 19. Every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith.

one party from taking unfair advantage over the other. Evasion by a party of legitimate obligations after receiving the benefits under the contract would constitute unjust enrichment on his part. (see Royal Lines, Inc. vs. Court of Appeals, 143 SCRA 608 [1986].)

(5) *Liability for breach of contract.* — Although the contract imposes no penalty for its violation, a party cannot breach it with impunity. Our law on contracts recognizes the principle that actionable injury inheres in every contractual breach. (Boysaw vs. Interphil Promotions, Inc., 148 SCRA 635 [1987]; see Arts. 1170, 1191.) Interest may, in the discretion of the court, on equitable grounds, be allowed upon damages awarded for breach of contract. (see Art. 2210.)

The failure of either party to a contract to demand performance of the obligation of the other for an unreasonable length of time may render the contract ineffective where the contract does not provide for the period within which the parties may demand the performance of their respective undertakings but the parties did not contemplate that the same could be made indefinitely. (Villamor vs. Court of Appeals, 202 SCRA 607 [1991].) The mere failure of a party to respond to a demand letter in the absence of other circumstances making an answer requisite or natural does not constitute an implied admission of liability. (Phil. First Insurance Co., Inc. vs. Wallen Phils. Shipping, Inc., 582 SCRA 457 [2009].)

(6) *Preservation of interest of promisee.* — A breach upon the contract confers upon the injured party a valid cause for recovering that which may have been lost or suffered. The remedy serves to preserve the interest of the promisee of having the benefit of his bargain, or in being reimbursed for loss caused by reliance on the contract, or in having restored to him any benefit that he has conferred on the other party.

The effect of every infraction is to create a new duty, that is, to make recompense to the one who has been injured by the failure of another to observe his contractual obligation unless he can show extenuating circumstances. (FGU Insurance Corporation vs. G.P. Sarmiento Trucking Corporation, 386 SCRA 312 [2002]; see Art. 1170.)

ILLUSTRATIVE CASES:

1. *Binding force of an oral agreement inconsistent with a prior written one.*

*Facts:* X verbally agrees to pay Y the balance of an account in advance, notwithstanding the different stipulation of a prior written agreement.

*Issue:* Is X bound to perform said obligation?

Held: Yes. Since he agreed to pay Y the balance of the account independently of the terms of the written contract, he must perform his obligation to pay according to the tenor of his verbal agreement which has the force of law between them. *(Hijos de I. de la Rama vs. Inventor, 12 Phil. 45 [1908].)*

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2. *Validity of contract stipulating that in case of failure of debtor to pay amount of loan, his property shall be considered sold to creditor.*

*Facts:* D borrowed from C money to be paid within a certain period, under the agreement that, if D fails to pay at the expiration of said period, the house and lot described in the contract would be considered sold for the amount of the loan.

D failed to pay as promised. C brought action for the delivery of the house and lot.

*Issue:* Are both contracts valid and, therefore, should be given effect?

*Held:* Yes. The fact that the parties have agreed at the same time, in such a manner that the fulfillment of the promise of sale would depend upon the non-payment or return of the amount loaned has not produced any change in the nature and legal conditions of either contract, or any essential defect which would nullify them.

As the amount loaned has not been paid and continues in possession of the debtor, it is only just that the promise of sale be carried into effect, and the necessary instruments be executed. That which is agreed to in a contract is law between the parties, and must be enforced. *(Alcantara vs. Alinea, 8 Phil. 111 [1907].)*

*Note:* In the above case, the court found that no contract of mortgage, pledge, or antichresis was entered into. (see Arts. 2088, 2137.)

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3. *Validity of contract for attorney's fees where amount stipulated is unreasonable.*

*Facts:* D executed a promissory note in favor of C for the purchase price of a truck sold by the latter. In the note, D bound himself to pay an additional 25% as attorney's fees in the event of becoming it necessary for C to employ counsel to enforce its collection.

*Issue:* Has the court the power to ignore the contract as to attorney's fees, considering that a contract has the force of law between the contracting parties?

*Held:* Yes. Where no special agreement is made by the parties with reference thereto, the courts are authorized to determine the amount to be paid to an attorney as reasonable compensation for his professional services; and even where parties have made a written agreement as to the fee, the courts have the power to ignore their contract, if the amount fixed is unconscionable or unreasonable, and to limit the fee to a reasonable amount.[10] *(Bachrach vs. Golingco, 35 Phil. 138 [1916].)*

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4. *A big corporation, to avoid cancellation of contract it has breached, pleaded considerations of equity.*

*Facts:* The contract between the parties (two big real estate corporations) was a contract to sell or conditional with title expressly reserved in S (seller) until the suspensive condition of full and punctual payment of the full price by B (buyer) shall have been met on pain of automatic cancellation of the contract upon failure to pay any of the monthly installments.

B failed to pay the P5,000.00 monthly installments notwithstanding that it was punctually collecting P10,000.00 monthly rentals from the lessee of the property.

*Issue:* The main issue posed by B is that there has been no breach of contract by it; and assuming there was, S was not entitled to rescind or resolve the contract without recoursing to judicial process.

*Held:* B only pleads that it be given special treatment and that the cancellation of its contract be somehow rejected notwithstanding S's clear right under the contract and the law to do so.

The contract between S and B, entered into with the assistance of counsel and with full awareness of the import of its terms and conditions, is the binding law between them and equity cannot be pleaded by one who has not come with clean hands nor complied therewith in good faith but instead willfully breached the contract.

"Its time to put an end to the fiction that corporations are people. The business of big corporations such as the protagonists at bar is business. They are bound by the lawful contracts that they enter into and they do not ask for nor are they entitled to considerations of equity." *(Luzon Brokerage Co., Inc. vs. Maritime Bldg. Co., Inc., 86 SCRA 305 [1978].)*

[10]The validity of contingent fee agreement in large measure depends on the reasonableness of the stipulated fees under the circumstances of each case. The reduction of unreasonable attorney's fees is within the regulatory powers of the courts to protect clients from unjust charges. (Taganas vs. National Labor Relations Commission, 248 SCRA 133 [1995]; see Sec. 13, Canons of Professional Ethics; Sec. 24, Rule 138, Rules of Court.)

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5. *Corporation unconditionally undertook to redeem preferred shares at specified dates.*

*Facts:* The terms and conditions of the Purchase Agreement shows that the parties intended the repurchase of the preferred shares in question on the respective dates to be an absolute obligation made manifest by the fact that a surety was required to see to it that the obligation is fulfilled in the event of the corporation's inability to do so.

Defendant corporation contends that it is beyond its power and competence to redeem the preferred shares due to financial reverses.

*Issue:* Can this contention serve as a legal justification for its failure to perform its obligation under the agreement?

*Held:* No. The unconditional undertaking of the corporation does not depend upon its financial ability: it constitutes a debt which is defined "as an obligation to pay money at some *fixed future* time, or at a time which becomes definite and fixed by acts of either party and which they expressly or impliedly agree to perform in the contract." The Purchase Agreement constitutes the law between the parties. *(Lirag Textiles Mill, Inc. vs. Social Security System, 153 SCRA 338 [1987].)*

**ART. 1160. Obligations derived from quasi-contracts shall be subject to the provisions of Chapter 1, Title XVII, of this Book. (n)**

## Quasi-contractual obligations.

Article 1160 treats of obligations arising from quasi-contracts or contracts implied in law.

A *quasi-contract* is that juridical relation resulting from certain lawful, voluntary and unilateral acts by virtue of which the parties become bound to each other to the end that no one will be unjustly enriched or benefited at the expense of another. (Art. 2142.)

It is not, properly, a contract at all. In a contract, there is a meeting of the minds or consent; the parties must have deliberately entered into a formal agreement. In a quasi-contract, there is no consent but the same is supplied by fiction of law. In other words, the law considers the parties as having entered into a contract, irrespective of their intention, to prevent injustice. Corollarily, if one who claims having enriched somebody has done so pursuant to a contract with a third party, his cause of action should be against the latter, who, in turn,

may, if there is any ground therefor, seek relief against the party benefited. (Cruz vs. J.M. Tuason & Co., Inc., 76 SCRA 543 [1977].)

Quasi-contracts are governed by the Civil Code, more particularly, by Articles 2142-2175, Chapter I, Title XVII.

ILLUSTRATIVE CASES:

1. *When a party benefited at the expense of another not liable to the latter.*

*Facts:* By virtue of an agreement between X and Y, X assisted Y in improving a large tract of land which was later declared by the court as belonging to C.

*Issue:* Has X the right to be reimbursed by Z for X's services and expenses on the ground that the improvements are being used and enjoyed by Z?

*Held:* No. From the language of Article 2142, it is obvious that a presumed quasi-contract cannot emerge as against one party when the subject matter thereof is already covered by an existing contract with another party. X's cause of action should be against Y who, in turn, may seek relief against Z. *(Cruz vs. J.M. Tuazon Co., Inc., supra.)*

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2. *Bank paid the seller of goods under an expired letter of credit but the goods subject thereof were voluntarily received and kept by the buyer which refused to pay the bank.*

*Facts:* X opened with B (bank) a domestic letter of credit (LC) in favor of Y for the purchase from the latter of hydraulic loaders. B paid Y for the equipment after the expiration of the letter of credit. X refused to pay B claiming that there was breach of contract by B which acted in bad faith in paying Y knowing that Y delivered the loaders to X after the expiry date of the subject LC.

X offered to return the loaders to B which refused to take possession three (3) years after X accepted delivery, when B made a demand for payment.

*Issue:* Was it proper for B to pay the LC which had long expired or been cancelled?

*Held:* B should not have paid the LC which had become invalid upon the lapse of the period fixed therein. Be that as it may, X should pay B the amount B expended for the equipment belatedly delivered by Y and voluntarily *received* and *kept* by X. B's right to seek recovery from X is

anchored, not upon the inefficacious LC, but on Article 2142 of the Civil Code.

X was not without fault in the transactions in view of its unexplained inaction for almost four (4) years with regard to the status of the ownership or possession of the loaders and the fact that it formalized its offer to return the equipment only after B's demand for payment, which came more than three (3) years after X accepted delivery.

When both parties to a transaction are mutually negligent in the performance of their obligations, the fault of one cancels the negligence of the other and as in this case, their rights and obligations may be determined equitably under the law proscribing unjust enrichment. *(Rodzssen Supply, Inc. vs. Far East Bank & Trust Co., 357 SCRA 618 [2001].)*

**Kinds of quasi-contracts.**

The principal kinds of quasi-contracts are *negotiorum gestio* and *solutio indebiti.*

(1) *Negotiorum gestio* is the voluntary management of the property or affairs of another without the knowledge or consent of the latter. (Art. 2144.) Thus, if through the efforts of X, a neighbor, the house of Y was saved from being burned, Y has the obligation to reimburse X for the expenses X incurred although Y did not actually give his consent to the act of X in saving his house on the principle of quasi-contract.

This juridical relation does not arise in either of these instances:

(a) When the property or business is not neglected or abandoned, in which case the provisions of the Civil Code regarding unauthorized contracts (Arts. 1317, 1403[1], 1404.) shall govern; or

(b) If, in fact, the manager has been tacitly authorized by the owner, in which case the rules on agency shall govern. (Art. 2144.)

(2) *Solutio indebiti* is the juridical relation which is created when something is received when there is no right to demand it and it was unduly delivered through mistake. (Art. 2154.) The obligation to pay money mistakenly paid arises from the moment said payment was made, and not from the time the payee admits the obligation to reimburse. (Comm. of Internal Revenue vs. Esso Standard Eastern, Inc., 172 SCRA 364 [1989].) Under the principle, the government has to restore (credit or refund) to the taxpayer the amounts representing

erroneous payments of taxes. (Phil. Geothermal, Inc. vs. Comm. of Internal Revenue, 465 SCRA 308 [2005].) The quasi-contract of *solutio indebiti* is based on the ancient principle that no one shall enrich himself unjustly at the expense of another.

*Solutio indebiti* applies where:

(a) payment is made when there exists no binding relation between the payor, who has no duty to pay, and the person who received the payment; and

(b) the payment is made through mistake[11] and not through liberality or some other cause. (Power Commercial and Industrial Corp. vs. Court of Appeals, 274 SCRA 597 [1997]; National Commercial Bank of Saudi Arabia vs. Court of Appeals, 396 SCRA 541 [2003]; Moreño-Lenifer vs. Wolf, 144 SCRA 584 [2004]; Bank of the Phil. Islands vs. Sarmiento, 484 SCRA 261 [2006].)

ILLUSTRATIVE CASES:

1. *Recovery of taxes paid under a mistake.*

*Facts:* X, a tax-exempt cooperative store, paid taxes to the City of Manila, believing that it was liable.

*Issue:* May X recover the payment?

*Held:* Yes, as it was made under a mistake. *(UST Cooperative Store vs. City of Manila, 15 SCRA 656 [1965].)*

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2. *Recovery of backwages paid which are legally due.*

*Facts:* X, an employee of Cebu City, sued certain officials of the City for claim of backwages.

*Issue:* May the City of Cebu successfully recover the payment later made by it to X on the ground that it was not made a party to the case?

*Held:* No, because a judgment against a municipal officer in his official capacity binds the city. The city was under obligation to make the payment. It cannot, therefore, be said that the payment was made by reason of mistake. *(City of Cebu vs. Piccio and Caballero, 110 Phil. 870 [1969].)*

[11] Art. 2163. It is presumed that there was a mistake in the payment if something which had never been due or had already been paid was delivered; but he from whom the return is claimed may prove that the delivery was made out of liberality or for any other just cause. (1901)

(3) *Other cases.* — Other examples of quasi-contracts are provided in Article 2164 to Article 2175 of the Civil Code.[12]

The cases that have been classified as quasi-contracts are of infinite variety, and when for some reason recovery cannot be had on a true contract, recovery may be allowed on the basis of a quasi-contract in view of the peculiar circumstances or factual environment to the end that a recipient of benefits or favors resulting from lawful, voluntary and unilateral acts of another may not be unjustly enriched at the expense of the latter.[13] (Phil. National Bank vs. Court of Appeals, 217 SCRA 347 [1993].)

**ART. 1161. Civil obligations arising from criminal offenses shall be governed by the penal laws,[14] subject to the provisions of Article 2177,[15] and of the pertinent provisions of Chapter 2, Preliminary Title on Human Relations,[16] and of Title XVIII of this Book, regulating damages. (1092a)**

## Civil liability arising from crimes or delicts.

This article deals with civil liability arising from crimes or delicts.

(1) The commission of an offense has a two-pronged effect: one, on the public as it breaches the social order and the other, upon the private victim as it causes personal sufferings or injury, each of which is addressed, respectively, by the imposition of heavier punishment on the accused and by an award of additional damages to the victim. (People vs. Catubig, 363 SCRA 621 [2001].)

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[12]Art. 2143. The provisions for quasi-contracts in this Chapter do not exclude other quasi-contracts which may come within the purview of the preceding article. (n)

[13]*Quantum meruit* allows recovery of the reasonable value regardless of any agreement as to value. It entitles the party to "as much as he reasonably *deserves,*" as distinguished from *quantum valebant* or to "as much as what is reasonably *worth.*" Recovery based on *quantum meruit* presents a justiciable question because its settlement requires the application of judgment and discretion and cannot be adjusted by simple arithmetical processes. (F.F. Mañacop Construction Co., Inc. vs. Court of Appeals, 266 SCRA 235 [1997].) The doctrine of *quantum meruit* prevents undue enrichment based on the equitable postulate that it is unjust for a person to retain benefit without paying for it. (Philippine National Bank vs. Shellink Planners, Inc., 473 SCRA 552 [2006].)

[14]The pertinent provisions are Articles 100 to 113 of the Revised Penal Code.

[15]Art. 2177. Responsibility for fault or negligence under the preceding article [Art. 2176, Note 19.] is entirely separate and distinct from the civil liability arising from negligence under the Penal Code. But the plaintiff cannot recover damages twice for the same act or omission of the defendant. (n)

[16]Among the pertinent provisions are Articles 29 to 35 of the Civil Code.

(2) Oftentimes, the commission of a crime causes not only moral evil but also material damage. From this principle, the rule has been established that every person criminally liable for a felony[17] is also civilly liable. (Art. 100, Revised Penal Code; see Albert, the Revised Penal Code Annotated, p. 276.) In crimes, however, which cause no material damage (like contempt, insults to person in authority, gambling, violations of traffic regulations, etc.), there is no civil liability to be enforced. But a person not criminally responsible may still be liable civilly. (Art. 29; Rules of Court, Rule 111, Sec. 2[c].)

**Reservation of right to recover civil liability.**

Under the present rule, only the civil liability arising from the offense charged is deemed instituted with the criminal action unless the offended party waives the civil action, reserves his right to institute it separately, or institutes the civil action prior to the criminal action. There is no more need for a reservation of the right to file the independent civil actions under Articles 32, 33, 34 and 2176 of the Civil Code.

The reservation and waiver referred to refer only to the civil action for the recovery of the civil liability arising from the offense charged. This does not include recovery of civil liability under Articles 32, 33, 34 and 2176 of the Civil Code of the Philippines arising from the same act or omission which may be prosecuted separately even without a reservation. (DMPI Employees Credit Cooperative, Inc. vs. Velez, 371 SCRA 72 [2001]; Hambon vs. Court of Appeals, 399 SCRA 255 [2003]; see Secs. 1, 2, 3, Rule 111, Revised Rules of Criminal Procedure; see Notes 19, 25.)

**Scope of civil liability.**

The extent of the civil liability arising from crimes is governed by the Revised Penal Code and the Civil Code.[18]

This civil liability includes:

(1) Restitution;

(2) Reparation for the damage caused; and

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[17] A *felony* is an act or omission punishable by law. It is committed with criminal intent or by means of negligence. (Arts. 3, 365, Revised Penal Code.)

[18] Articles 2202, 2204-2206, 2208, 2211, 2219-2220, 2222, and 2230 of the Civil Code govern the amount of damages recoverable by reason of crime.

(3) Indemnification for consequential damages. (Art. 104, Revised Penal Code.)

EXAMPLE:

X stole the car of Y. If X is convicted, the court will order X: (1) to return the car (or to pay its value if it was lost or destroyed); (2) to pay for any damage caused to the car; and (3) to pay such other damages suffered by Y as a consequence of the crime.

Where the trial court convicts an accused of a crime, without, however, ordering payment of any indemnity, it has been held that the Supreme Court, on appeal, may modify the decision by ordering indemnification of the offended party pursuant to Articles 100, 104(3), and 107 of the Revised Penal Code. (People vs. Peña, 80 SCRA 589 [1977]; see Note 2.)

**ART. 1162. Obligations derived from quasi-delicts shall be governed by the provisions of Chapter 2, Title XVII of this Book, and by special laws. (1093a)**

## Obligations arising from quasi-delicts.

The above provision treats of obligations arising from quasi-delicts or torts. (see Arts. 2176[19] to 2194.)

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[19]Art. 2176. Whoever by act or omission causes damage to another, there being fault or negligence, is obliged to pay for the damage done. Such fault or negligence, if there is no pre-existing contractual relation between the parties, is called a quasi-delict and is governed by the provisions of this Chapter. [on Quasi-delicts]

The concept of quasi-delict as enunciated in Article 2176, includes not only injuries to persons but also damage to property. (Cinco vs. Canonoy, 90 SCRA 369 [1979].) The Supreme Court has held that "fault or negligence" in Article 2176 covers not only acts "not punishable by law" but also acts criminal in character, whether intentional and voluntary or negligent. Consequently, a separate civil action lies against the offender in a criminal act, whether or not he is found guilty or acquitted, provided, that the offended party is not allowed, if the offender is actually charged also criminally, to recover damages on both scores, and would be entitled in such eventuality only to the bigger award of the two, assuming the awards made in the two cases vary. (Elcano vs. Hill, 77 SCRA 98 [1977]; Virata vs. Ochoa, 81 SCRA 472 [1978].) Inasmuch as Articles 2176 and 2177 (see Note 2.) create a civil liability distinct and different from the civil action arising from the offense of negligence under the Revised Penal Code, no reservation of the right to file an independent civil action based on quasi-delict need be made in the criminal case. Section 2, Rule 111 of the Rules of Court is inoperative because of its inconsistency with Article 2177. Therefore, such right is not barred by the failure to reserve the same. But the action for enforcement of civil liability based on *culpa criminal* under Section 1, Rule 111 of the Rules of Court is deemed simultaneously instituted with the criminal action, unless expressly waived or reserved for separate application by the offended party. (Mendoza vs. Arrieta, 91 SCRA 113 [1979].)

A *quasi-delict*[20] is an act or omission by a person (tort feasor) which causes damage to another in his person, property, or rights giving rise to an obligation to pay for the damage done, there being fault or negligence but there is no pre-existing contractual relation between the parties.[21] (Art. 2176.)

**Requisites of quasi-delict.**

Before a person can be held liable for quasi-delict, the following requisites must be present:

(1) There must be an act or omission by the defendant;

(2) There must be fault or negligence of the defendant;

(3) There must be damage caused to the plaintiff;

(4) There must be a direct relation or connection of cause and effect between the act or omission and the damage; and

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[20]It is the equivalent of tort in Anglo-American law. But "tort" under that system is much broader than the Spanish-Philippine concept of obligations arising from non-contractual negligence. "Tort" in Anglo-American jurisprudence includes not only negligence, but also intentional criminal acts, such as assault and battery, false imprisonment and deceit. In the general plan of the Philippine legal system, intentional and malicious acts are governed by the Revised Penal Code, although certain exceptions are made. (Report of the Code Commission, pp. 161-162.) However, the new Civil Code as enacted as well as rulings of the Supreme Court in a number of cases *(supra)*, reveal an intent to adopt a broad interpretation of the provision on quasi-delicts in Article 2176 to include intentional acts.

[21]Art. 2180. The obligation imposed by Article 2176 is demandable not only for one's own acts or omissions, but also for those of persons for whom one is responsible.

The father and, in case of his death or incapacity, the mother, are responsible for the damages caused by the minor children who live in their company.

Guardians are liable for damages caused by the minors or incapacitated persons who are under their authority and live in their company.

The owners and managers of an establishment or enterprise are likewise responsible for damages caused by their employees in the service of the branches in which the latter are employed or on the occasion of their functions.

Employers shall be liable for the damages caused by their employees and household helpers acting within the scope of their assigned tasks, even though the former are not engaged in any business or industry.

The State is responsible in like manner when it acts through a special agent; but not when the damage has been caused by the official to whom the task done properly pertains, in which case what is provided in Article 2176 shall be applicable.

Lastly, teachers or heads of establishments of arts and trades shall be liable for damages caused by their pupils and students or apprentices, so long as they remain in their custody.

The responsibility treated of in this article shall cease when the persons herein mentioned prove that they observed all the diligence of a good father of a family to prevent damage. (1903a)

(5) There is no pre-existing contractual relation between the parties.[22]

**Crime distinguished from quasi-delict.**

The following are the distinctions:

(1) In crime or delict, there is criminal or malicious intent or criminal negligence, while in quasi-delict, there is only negligence;

(2) Crime affects public interest, while quasi-delict concerns private interest;

(3) In crime, there are generally two liabilities: criminal and civil,[23] while in quasi-delict, there is only civil liability;

(4) In crime or delict, the purpose is punishment, while in quasi-delict, indemnification[24] of the offended party;

(5) Criminal liability can not be compromised or settled by the parties themselves, while the liability for quasi-delict can be compromised as any other civil liability;

(6) In crime, the guilt of the accused must be proved beyond reasonable doubt, while in quasi-delict, the fault or negligence of the defendant need only be proved by preponderance of evidence; and

(7) In crime, the liability of the person responsible for the author of the negligent act or omission is subsidiary, while in quasi-delict, it is direct and primary.

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[22]A contractual obligation can be breached by tort, and when the same act or omission causes the injury, one resulting in *culpa contractual* and the other in *culpa aquiliana*, Article 2194 which imposes solidary responsibility on two or more persons who are liable for a quasi-delict, can well apply. In fine, a liability for tort may arise even under a contract, where tort is that which breaches the contract. Stated differently, when an act which constitutes a breach of contract would have itself constituted the source of a quasi-delictual liability had no contract existed between the parties, the contract can be said to have been breached by tort, thereby allowing the rules on tort to apply. (Light Rail Transit Authority vs. Navidad, 397 SCRA 75 [2003].)

[23]Delicts are not as broad as quasi-delicts because the former are punished only if there is a penal law clearly covering them, while the latter include all acts in which any kind of fault or negligence intervenes. But not all violations of the penal laws produce civil responsibility, such as begging in violation of ordinances, violation of gambling laws, and infraction of traffic rules when no injury or damage is caused. (Barredo vs. Garcia, 73 Phil. 607 [1941].)

[24]The Civil Code provisions on damages especially applicable to obligations derived from quasi-delicts (Arts. 2176-2194.) are Articles 2202, 2206, 2211, 2214-2215, 2219, 2222, and 2231.

**Recovery of damages twice for the same act or omission prohibited.**

The same negligent act or omission causing damage may produce civil liability arising from a crime under Article 100 of the Revised Penal Code *(supra.)* or create an action for quasi-delict under Article 2176. (see Barredo vs. Garcia and Almario, 73 Phil. 607 [1942]; see Elcano vs. Hill, 77 SCRA 98 [1977].) The Revised Penal Code in Article 365 punishes not only reckless but also simple negligence.

Under Article 1157, quasi-delict and an act or omission punishable by law are two different sources of obligations. Inasmuch as civil liability co-exists with criminal responsibility in negligence cases, the offended party has the option between an action for enforcement of civil liability based on *culpa criminal* under Article 100 of the Revised Penal Code and an action for recovery of damages based on *culpa aquiliana* under Article 2177.[25] (see Art. 1161.)

These two causes of action (*ex delicto* or *ex quasi delicto*) may be availed of subject to the caveat that the offended party cannot recover damages twice for the same act or omission or under both causes. Since these two (2) civil liabilities are distinct and independent of each other, the failure to recover in one will not necessarily preclude recovery in the other. (Equitable Leasing Corporation vs. Suyom, 388 SCRA 445 [2002].)

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[25]The 2000 Rules of Criminal Procedure deleted the requirement of reserving independent civil actions and allowed these to proceed separately from criminal ones. Thus, the civil actions referred to in Articles 32, 33, 34, and 2176 of the Civil Code shall remain "separate, distinct and independent" of any criminal prosecution based on the same act or omission. (Neplum, Inc. vs. Orbeso, 384 SCRA 466 [2002]; see Casupanan vs. Laroya, 388 SCRA 28 [2002]; Cancio, Jr. vs. Isip, 391 SCRA 393 [2002].)

# Chapter 2

# NATURE AND EFFECT OF OBLIGATIONS

**ART. 1163. Every person obliged to give something is also obliged to take care of it with the proper diligence of a good father of a family, unless the law or the stipulation of the parties requires another standard of care. (1094a)**

### Meaning of specific or determinate thing.

The above provision refers to an obligation to give a specific or determinate thing.

A thing is said to be *specific* or *determinate* when it is particularly designated or physically segregated from all others of the same class. (Art. 1459.)

EXAMPLES:

(1) The watch I am wearing.

(2) The car sold by X.

(3) My dog named "Terror."

(4) The house at the corner of Rizal and Del Pilar Streets.

(5) The Toyota car with Plate No. AAV 344.

(6) This cavan of rice.

(7) The money I gave you.

### Meaning of generic or indeterminate thing.

A thing is *generic* or *indeterminate* when it refers only to a class or genus to which it pertains and cannot be pointed out with particularity.

EXAMPLES:

(1) a Bulova calendar watch.

(2) a 2006 model Japanese car.

(3) a police dog.

(4) a cavan of rice.

(5) the sum of P10,000.00.

**Specific thing and generic thing distinguished.**

(1) A determinate thing is identified by its individuality. The debtor cannot substitute it with another although the latter is of the same kind and quality without the consent of the creditor. (Art. 1244.)

(2) A generic thing is identified only by its specie. The debtor can give anything of the same class as long as it is of the same kind.

EXAMPLES:

(1) If D's obligation is to deliver to C a Bulova calendar watch, D can deliver any watch as long as it is Bulova with calendar.

But if D's obligation is to deliver to C a particular watch, the one D is wearing, D cannot substitute it with another watch without C's consent nor can C require D to deliver another watch without D's consent although it may be of the same kind and value. (see Arts. 1244, 1246.)

(2) If D's obligation is to deliver to C one of his cars, the object refers to a class which in itself is determinate.

Here, the particular thing to be delivered is determinable without the need of a new contract between the parties (see Art. 1349.); it becomes determinate upon its delivery.

**Duties of debtor in obligation to give a determinate thing.**

They are:

(1) To preserve or take care of the thing due;

(2) To deliver the fruits of the thing (see Art. 1164.);

(3) To deliver its accessions and accessories (see Art. 1166.);

(4) To deliver the thing itself (see Arts. 1163, 1233, 1244; as to kinds of delivery, Arts. 1497 to 1501.); and

(5) To answer for damages in case of non-fulfillment or breach. (see Art. 1170.)

**Obligation to take care of the thing due.**

(1) *Diligence of a good father of a family.* — In obligations to give (real obligations), the obligor has the incidental duty to take care of the thing due with the diligence of a good father of a family pending delivery. The phrase has been equated with *ordinary care* or that diligence which an average (a reasonably prudent) person exercises over his own property.

(2) *Another standard of care.* — However, if the law or the stipulation of the parties provides for another standard of care (slight or extraordinary diligence), said law or stipulation must prevail. (Art. 1163.)

(a) Under the law, for instance, a common carrier (person or company engaged in the transportation of persons and/or cargoes) is "bound to carry the passengers safely as far as human care and foresight can provide, using utmost (extraordinary) diligence of very cautious persons, with a due regard for all the circumstances." (Art. 1755.) In case of accident, therefore, the common carrier will be liable if it exercised only ordinary diligence or the diligence of a good father of a family.

(b) Banks are duty bound to treat the deposit accounts of their depositors with the highest degree of care where the fiduciary nature of their relationship with their depositors is concerned. But such degree of diligence is not expected to be exerted by banks in commercial transactions that do not involve their fiduciary relationship with their depositors. (Reyes vs. Court of Appeals, 363 SCRA 51 [2001].)

(c) While parties may agree upon diligence which is more or less than that of a good father of a family, it is contrary to public policy (see Art. 1306.) to stipulate for absolute exemption from liability for any fault or negligence. (see Arts. 1173, 1174.) Thus, a stipulation exempting a carrier from liability for gross negligence is against public policy. (Heacock vs. Macondray, 32 Phil. 205 [1915]; see Arts. 1306, 1744, 1745.)

(3) *Factors to be considered.* — The diligence required depends upon the nature of the obligation and corresponds with the circumstances of the person, of the time, and of the place. (Art. 1173.) It is not necessarily the standard of care one always uses in the protection of his own property. As a general rule, the debtor is not liable if his failure to preserve the thing is not due to his fault or negligence but to fortuitous events or *force majeure.* (Art. 1174.)

(4) *Reason for debtor's obligation.* — The debtor must exercise diligence to insure that the thing to be delivered would subsist in the same condition as it was when the obligation was contracted. Without the accessory duty to take care of the thing, the debtor would be able to afford being negligent and he would not be liable even if the property is lost or destroyed, thus rendering illusory the obligation to give. (8 Manresa 35-37.)

### Duties of debtor in obligation to deliver a generic thing.

They are:

(1) To deliver a thing which is of the quality intended by the parties taking into consideration the purpose of the obligation and other circumstances (see Art. 1246.); and

(2) To be liable for damages in case of fraud, negligence, or delay, in the performance of his obligation, or contravention of the tenor thereof. (see Art. 1170.)

**ART. 1164. The creditor has a right to the fruits of the thing from the time the obligation to deliver it arises. However, he shall acquire no real right over it until the same has been delivered to him. (1095)**

### Different kinds of fruits.

The fruits mentioned by the law refer to natural, industrial, and civil fruits.

(1) *Natural fruits* are the spontaneous products of the soil, and the young and other products of animals, *e.g.,* grass; all trees and plants on lands produced without the intervention of human labor.

(2) *Industrial fruits* are those produced by lands of any kind through cultivation or labor, *e.g.,* sugar cane; vegetables; rice; and all products of lands brought about by reason of human labor.

(3) *Civil fruits* are those derived by virtue of a juridical relation, *e.g.*, rents of buildings, price of leases of lands and other property and the amount of perpetual or life annuities or other similar income. (Art. 442.)

**Right of creditor to the fruits.**

This article is a logical application of the basic principle stated in Article 712, paragraph two of the Civil Code that "Ownership and other real rights over property are acquired and transmitted by law, by donation, by testate and intestate succession, and in consequence of certain contracts, by tradition." (see Arts. 734, 774, 777; Fidelity & Deposit Co. vs. Wilson, 8 Phil. 51 [1907].)

By law, the creditor is entitled to the fruits of the thing to be delivered from the time the obligation to make delivery of the thing arises. The intention of the law is to protect the interest of the obligee should the obligor commit delay, purposely or otherwise, in the fulfillment of his obligation.

In case of rescission, the parties are under "obligation to return the things which were the object of the contract, together with their fruits and the price with its interest." (Art. 1385.)

**When obligation to deliver arises.**

(1) Generally, the obligation to deliver the thing due and, consequently, the fruits thereof, if any, arises from the time of the perfection of the contract. Perfection in this case refers to the birth of the contract or to the meeting of the minds between the parties. (Arts. 1305, 1315, 1319.)

(2) If the obligation is subject to a suspensive condition or period (Arts. 1179, 1189, 1193.), it arises upon fulfillment of the condition or arrival of the period. However, the parties may make a stipulation to the contrary as regards the right of the creditor to the fruits of the thing.

(3) In a contract of sale, the obligation arises from the perfection of the contract even if the obligation is subject to a suspensive condition or a suspensive period where the price has been paid.

(4) In obligations to give arising from law, quasi-contracts, delicts, and quasi-delicts, the time of performance is determined by the specific provisions of law applicable.

EXAMPLE:

S sold his horse to B for P15,000.00. No date or condition was stipulated for the delivery of the horse. While still in the possession of S, the horse gave birth to a colt.

Who has the right to the colt?

In a contract of sale "all the fruits shall pertain to the vendee from the day on which the contract was perfected." (Art. 1537, 2nd par.) Hence, B is entitled to the colt. This holds true even if the delivery is subject to a suspensive condition (see Art. 1179; *e.g.*, upon the demand of B) or a suspensive period (see Art. 1193; *e.g.*, next month) *if B has paid the purchase price*.

But S has a right to the colt if it was born before the obligation to deliver the horse has arisen (Art. 1164.) *and B has not yet paid the purchase price.* In this case, upon the fulfillment of the condition or the arrival of the period, S does not have to give the colt and B is not obliged to pay legal interests on the price since the colt and the interests are deemed to have been mutually compensated. (see Art. 1187.)

### Meaning of personal right and real right.

(1) *Personal right*[1] is the right or power of a person (creditor) to demand from another (debtor), as a definite passive subject, the fulfillment of the latter's obligation to give, to do, or not to do.

(2) *Real right*[2] is the right or interest of a person over a specific thing (like ownership, possession, mortgage, lease record) without a definite passive subject against whom the right may be personally enforced.

### Personal right and real right distinguished.

While in personal right there is a definite active subject and a definite passive subject, in real right, there is only a definite active subject without any definite passive subject.

A personal right is, therefore, binding or enforceable only against a particular person while a real right is directed against the whole world.

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[1]Also called *jus in personam* or *jus ad rem.*

[2]Also called *jus in re.*

EXAMPLE:

X is the owner of a parcel of land under a torrens title registered in his name in the Registry of Property. His ownership is a real right directed against everybody. There is no definite passive subject.

If the land is claimed by Y who takes possession, X has a personal right to recover from Y, as a definite passive subject, the property.

If the same land is mortgaged by X to Z, the mortgage, if duly registered, is binding against third persons. A purchaser buys the land subject to the mortgage which is a real right.

**Ownership acquired by delivery.**

Ownership and other real rights over property are acquired and transmitted by law, by donation, by testate and intestate succession, and in consequence of certain contracts by tradition (Art. 712.) or delivery. Delivery in sale may be actual or real, constructive or legal, or in any other manner signifying an agreement that the possession of the thing sold is transferred from the vendor to the vendee.[3] (see Arts. 1496-1501.)

The meaning of the phrase "he shall acquire no real right over it until the same has been delivered to him," is that the creditor does not become the owner until the specific thing has been delivered to him. Hence, when there has been no delivery yet, the proper action of the creditor is not one for recovery of possession and ownership but one for specific performance or rescission of the obligation. (see Art. 1165.)

ILLUSTRATIVE CASE:

*A document transfers to a person certain funds in the possession of another but there is no actual delivery of said funds.*

*Facts:* For the security of the Government, X Company (and another company) became a surety on the official bond of W, an employee of the Government for the sum of $15,000.00. W defaulted in the amount of $8,900.00 and X Company paid the Government the sum of $14,462.00. When W was apprehended, he had on his person $750.00 which amount was turned over to B, the Insular Treasurer.

[3]Contracts only constitute titles or rights to the transfer or acquisition of ownership, while delivery or tradition is the mode of accomplishing the same. Thus, sale by itself does not transfer or effect ownership. The most that a sale does is to create the obligation to transfer ownership. It is delivery, as a consequence of sale, that actually transfers ownership. (San Lorenzo Dev. Corp. vs. Court of Appeals, 449 SCRA 99 [2005].)

Later, W signed a document transferring to T all his rights to said $785.00 for professional services rendered by the latter as attorney's fee. B was duly notified of the transfer.

X filed an action against W to recover the sum of $785.00 in partial payment of the amount paid by X to the Government. T filed a complaint in intervention and claimed the money as his.

*Issue:* On the basis of these facts, will the complaint of T prosper?

*Held:* No. (1) *Ownership was not acquired by T.* — The delivery of a thing constitutes a necessary and indispensable requisite for the purpose of acquiring the ownership of the same by virtue of a contract. The transfer by itself, and afterwards the notification to B, did not produce the effect of delivery to T of the funds so transferred. (see Arts. 1497, 1498, 1501.) To have this effect, it would have been necessary that the delivery of the funds had been made directly to T. Therefore, by reason of the non-delivery, T did not acquire the ownership of the property transferred to him by W.

(2) *Mere personal right was acquired by T.* — It is only the *jus ad rem,* and not the *jus in re,* that was acquired by T by virtue of the transfer made by the consent of the transferor and the transferee but not consummated by the delivery which never came to pass and which delivery was the object of such transfer. (*Fidelity & Deposit Co. vs. Wilson, 8 Phil. 51 [1907];* see also Cruzado vs. Bustos, 34 Phil. 17 [1915].)

**ART. 1165. When what is to be delivered is a determinate thing, the creditor, in addition to the right granted him by Article 1170, may compel the debtor to make the delivery.**

**If the thing is indeterminate or generic, he may ask that the obligation be complied with at the expense of the debtor.**

**If the obligor delays, or has promised to deliver the same thing to two or more persons who do not have the same interest, he shall be responsible for any fortuitous event until he has effected the delivery. (1096)**

## Remedies of creditor in real obligation.

(1) In a *specific real obligation* (obligation to deliver a determinate thing), the creditor may exercise the following remedies or rights in case the debtor fails to comply with his obligation:

(a) demand specific performance or fulfillment (if it is still possible) of the obligation with a right to indemnity for damages; or

(b) demand rescission or cancellation (in certain cases) of the obligation also with a right to recover damages (Art. 1170.); or

(c) demand the payment of damages only (see Art. 1170.) where it is the only feasible remedy.

In an obligation to deliver a determinate thing, the very thing itself must be delivered. (Art. 1244.) Consequently, only the debtor can comply with the obligation. This is the reason why the creditor is granted the right to compel the debtor to make the delivery. (Art. 1165, par. 1.) It should be made clear, however, that the law does not mean that the creditor can use force or violence upon the debtor. The creditor must bring the matter to court and the court will be the one to order the delivery.

(2) A *generic real obligation* (obligation to deliver a generic thing), on the other hand, can be performed by a third person since the object is expressed only according to its family or genus. It is thus not necessary for the creditor to compel the debtor to make the delivery although he may ask for performance of the obligation. In any case, the creditor has a right to recover damages under Article 1170 in case of breach of the obligation.

The manner of compliance with an obligation to deliver a generic thing is governed by Article 1246. Under the Constitution, no person shall be imprisoned for non-payment of debt. (Art. III, Sec. 20 thereof.) However, a person may be subject to subsidiary imprisonment for non-payment of civil liability adjudged in a criminal case. (see Art. 1161.) The constitutional prohibition refers to purely civil debt or one arising from contractual obligations only.

**Where debtor delays or has promised delivery to separate creditors.**

Paragraph 3 gives two instances when a fortuitous event does not exempt the debtor from responsibility. It likewise refers to a determinate thing. An indeterminate thing cannot be the object of destruction by a fortuitous event because *genus nunquam perit* (genus never perishes). (see Arts. 1174, 1263.)

Delay is discussed in Article 1169, and fortuitous events, in Article 1174.

**ART. 1166. The obligation to give a determinate thing includes that of delivering all its accessions and accessories, even though they may not have been mentioned. (1097a)**

### Meaning of accessions and accessories.

(1) *Accessions* are the fruits of, or additions to, or improvements upon, a thing (the principal), *e.g.*, house or trees on a land; rents of a building; airconditioner in a car; profits or dividends accruing from shares of stocks; etc.

The concept includes *accession* in its three forms of building, planting, and sowing (see Art. 445.), and *accession natural,* such as alluvion (see Art. 457.), avulsion (see Art. 459.), change of course of rivers (see Arts. 461-462.), and formation of islands. (see Arts. 464-465.) "Fruits of the thing" are specifically provided for in Article 1164.

(2) *Accessories* are things joined to, or included with, the principal thing for the latter's embellishment, better use, or completion, *e.g.*, key of a house; frame of a picture; bracelet of a watch; machinery in a factory; bow of a violin.

Note that while accessions are not necessary to the principal thing, the accessory and the principal thing must go together but both accessions and accessories can exist only in relation to the principal.

### Right of creditor to accessions and accessories.

The general rule is that all accessions and accessories are considered included in the obligation to deliver a determinate thing although they may not have been mentioned. This rule is based on the principle of law that the accessory follows the principal. In order that they will be excluded, there must be a stipulation to that effect.

Unless otherwise stipulated, an obligation to deliver the accessions or accessories of a thing does not include the latter. Thus, a sale of the improvements (*e.g.*, house) upon a thing (*e.g.*, land) is not sufficient to convey title or any right to the thing. (see Pornellosa vs. Land Tenure Administration, 1 SCRA 375 [1961].) But the lease of a building or house naturally includes the lease of the lot, and the rentals include those of the lot for the occupancy of a building or house not only suggests but also implies the tenancy or possession in fact of the land on which it is constructed. (Caleon vs. Agus Development Corp., 207 SCRA 748 [1992].)

### Accession as a right.

Accession is also used in the sense of a right. In that sense, it may be defined as the right pertaining to the owner of a thing over its products and whatever is incorporated or attached thereto, either naturally or artificially. (3 Sanchez Roman 89; Art. 440.)

Accession includes, therefore, the right to the fruits and the right to the accessory. It is one of the rights which go to make up dominion or ownership. (3 Manresa 166.) But it is not, under the law, a mode of acquiring ownership. (see Art. 712.)

**ART. 1167. If a person obliged to do something fails to do it, the same shall be executed at his cost.**

**This same rule shall be observed if he does it in contravention of the tenor of the obligation. Furthermore, it may be decreed that what has been poorly done be undone. (1098)**

### Situations contemplated in Article 1167.

Article 1167 refers to an obligation to do, *i.e.*, to perform an act or render a service. It contemplates three situations:

(1) The debtor fails to perform an obligation to do; or

(2) The debtor performs an obligation to do but contrary to the terms thereof; or

(3) The debtor performs an obligation to do but in a poor manner.

### Remedies of creditor in positive personal obligation.

(1) If the debtor fails to comply with his obligation to do, the creditor has the right:

(a) to have the obligation performed by himself, or by another unless personal considerations are involved, at the debtor's expense; and

(b) to recover damages. (Art. 1170.)

(2) In case the obligation is done in contravention of the terms of the same or is poorly done, it may be ordered (by the court) that it be undone if it is still possible to undo what was done.

**Performance by a third person.**

A personal obligation to do, like a real obligation to deliver a generic thing, can be performed by a third person. While the debtor can be compelled to make the delivery of a specific thing (Art. 1165.), a specific performance cannot be ordered in a personal obligation to do because this may amount to involuntary servitude which, as a rule, is prohibited under our Constitution. (Art. III, Sec. 18[2] thereof.)

Where, however, the personal qualifications of the debtor are the determining motive for the obligation contracted (*e.g.,* to sing in a night club), the performance of the same by another would be impossible or would result to be so different that the obligation could not be considered performed. Hence, the only feasible remedy of the creditor is indemnification for damages. But where the obligation can still be performed at the expense of the debtor notwithstanding his failure or refusal to do so, the court is not authorized to merely grant damages to the creditor.

ILLUSTRATIVE CASE:

*Liability of debtor who fails to comply with an obligation to do.*

*Facts:* A delivered to B, a typewriter repairer, a portable typewriter for *routine* cleaning and servicing. B was not able to finish the job after some time despite repeated reminders made by A. Finally, B returned the typewriter unrepaired, some of the parts missing. A had the typewriter repaired by F Business Machines, and the repair job cost him P58.75 for labor or service and P31.10 for the missing parts or a total of P89.85.

The lower court rendered judgment ordering B to pay only P31.10.

*Issue:* Is B liable also for P58.75, the cost of the service expended in the repair?

*Held:* Yes. B contravened the tenor of his obligation (see Art. 1170.) because he not only did not repair the typewriter but returned it "in shambles." For such contravention, he is liable under Article 1167 for the cost of executing the obligation in a proper manner, which in the case should be the cost of the labor or service expended in its repair, because the obligation or contract was to repair it.

In addition, he is liable under Article 1170 for the cost of the missing parts for in his obligation to repair the typewriter he was bound, but failed or neglected to return it in the same condition it was when he received it. (*Chaves vs. Gonzales, 32 SCRA 547 [1970];* see Tanguilig vs. Court of Appeals, 266 SCRA 78 [1997].)

**ART. 1168. When the obligation consists in not doing, and the obligor does what has been forbidden him, it shall also be undone at his expense. (1099a)**

### Remedies of creditor in negative personal obligation.

In an obligation not to do, the duty of the obligor is to abstain from an act. Here, there is no specific performance. The very obligation is fulfilled in not doing what is forbidden. Hence, in this kind of obligation the debtor cannot be guilty of delay. (Art. 1169.)

As a rule, the remedy of the obligee is the undoing of the forbidden thing plus damages. (Art. 1170.) However, if it is not possible to undo what was done, either physically or legally, or because of the rights acquired by third persons who acted in good faith, or for some other reason, his remedy is an action for damages caused by the debtor's violation of his obligation. (see 8 Manresa 58.)

EXAMPLE:

S sold a land to B. It was stipulated that S would not construct a fence on a certain portion of his land adjoining that sold to B. Should S construct a fence in violation of the agreement, B can have the fence removed at the expense of S.

**ART. 1169. Those obliged to deliver or to do something incur in delay from the time the obligee judicially or extra-judicially demands from them the fulfillment of their obligation.**

**However, the demand by the creditor shall not be necessary in order that delay may exist:**

**(1) When the obligation or the law expressly so declares; or**

**(2) When from the nature and the circumstances of the obligation it appears that the designation of the time when the thing is to be delivered or the service is to be rendered was a controlling motive for the establishment of the contract; or**

**(3) When demand would be useless, as when the obligor has rendered it beyond his power to perform.**

**In reciprocal obligations, neither party incurs in delay if the other does not comply or is not ready to comply in a proper manner with what is incumbent upon him. From the moment**

**one of the parties fulfills his obligation, delay by the other begins. (1100a)**

### Meaning of delay.

The word *delay,* as used in the law, is not to be understood according to its meaning in common parlance. A distinction, therefore, should be made between ordinary delay and legal delay (default or *mora*) in the performance of an obligation.

(1) *Ordinary delay* is merely the failure to perform an obligation on time.

(2) *Legal delay* or *default* or *mora* is the failure to perform an obligation on time which failure, constitutes a breach of the obligation.

### Kinds of delay (mora).

They are:

(1) *Mora solvendi* or the delay on the part of the debtor to fulfill his obligation (to give or to do) by reason of a cause imputable to him;

(2) *Mora accipiendi* or the delay on the part of the creditor without justifiable reason to accept the performance of the obligation; and

(3) *Compensatio morae* or the delay of the obligors in reciprocal obligations (like in sale), *i.e.,* the delay of the obligor cancels the delay of the obligee, and *vice versa.*

### No delay in negative personal obligation.

In an obligation not to do, non-fulfillment may take place but delay is impossible for the debtor fulfills by *not* doing what has been forbidden him. (see Art. 1168.)

### Requisites of delay or default by the debtor.

There are three conditions that must be present before *mora solvendi* can exist or its effects arise:

(1) failure of the debtor to perform his (positive) obligation on the date agreed upon;

(2) demand (not mere reminder or notice) made by the creditor upon the debtor to fulfill, perform, or comply with his obligation which demand, may be either judicial (when a complaint is filed in court) or extra-judicial (when made outside of court, orally or in writing); and

(3) failure of the debtor to comply with such demand.

The above presupposes that the obligation is already due or demandable and liquidated. (see Art. 1279[4].) There is no delay if the obligation is not yet due or demandable.[4] A debt is liquidated when the amount is known or is determinable by inspection of the terms and conditions of relevant documents. Failure to furnish a debtor a detailed statement of account does not *ipso facto* result in an unliquidated obligation. (Selegna Management and Dev. Corp. vs. United Coconut Planters Bank, 489 SCRA 125 [2006].)

The creditor has the burden of proving that demand has been made.[5] It is incumbent upon the debtor, to relieve himself from liability, to prove that the delay was not caused by his fault, *i.e.*, there was no fraud or negligence on his part. (Arts. 1170, 1173, 1174.)

EXAMPLE:

S obliged himself to deliver to B a specific refrigerator on December 10.

If S does not deliver the refrigerator on December 10, he is only in ordinary delay in the absence of any demand from B although a period has been fixed for the fulfillment of the obligation. The law presumes that B is giving S an extension of time within which to deliver the refrigerator. Hence, there is no breach of the obligation and S is not liable for damages.

If a demand is made upon S by B on December 15 and S fails to deliver the refrigerator, S is considered in default only from the date.

If an action for specific performance is filed by B on December 20, the payment of damages for the default must commence on December 15 when he made the extra-judicial demand and not on December 20.

In the absence of evidence as to such extra-judicial demand, the effects of default arise from the date of the judicial demand, that is, from the filing of the complaint. (see Compania General de Tabacos vs. Areza, 7 Phil. 455 [1907]; Lopez vs. Tan Tioco, 8 Phil. 693 [1907]; Queblar vs. Garduño and Martinez, 62 Phil. 879 [1936].)

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[4]A demand is only necessary in order to put an obligor in a due and demandable obligation in delay. An extrajudicial demand is not required before a judicial demand. (Auto Corp. Group. vs. Intra Strata Assurance Corp., 556 SCRA 250 [2008].)

[5]A *grace period* is a right, not an obligation, of the debtor. It must not be likened to an obligation the non-payment of which under Article 1169 would generally still require judicial or extra-judicial demand before default can be said to arise. When unconditionally conferred, it is effective without further need of demand either calling for the payment of the obligation or for honoring the right. (Bricktown Dev't. Corp. vs. Amor Tierra Dev't. Corp., 239 SCRA 126 [1994].)

ILLUSTRATIVE CASES:

1. *Non-payment of taxes by mortgagor on mortgaged realty rendered entire loan due and payable but no demand was made either of the taxes or of loan itself.*

*Facts:* As security for a loan, R executed a real estate mortgage in favor of E. R bound himself to pay on time the taxes on the mortgaged property; otherwise, the entire loan would become due and payable. R failed to pay the taxes as stipulated. No demand was made by E either in respect of the taxes or the loan itself, the only notice given to R being the letter received by him from E's lawyer to the effect that he was taking the necessary steps to foreclose the mortgage extrajudicially because the taxes had not been paid.

Acting on the foregoing communication, R paid the back taxes complained of.

*Issue:* Did R incur in delay in the payment of the taxes and the loan?

*Held:* No, in view of the absence of previous demand for him to make such payment notwithstanding that the failure to pay the taxes rendered the entire loan due and demandable. None of the circumstances in Article 1169 which would dispense E from making the demand was present. In the light of the principal stipulation of the contract when the mortgage debt was to be paid, the non-payment of taxes was not a material breach of the contract.

In any event, there was substantial compliance with the obligation in this particular aspect so as to arrest effectively the foreclosure sale. *(De Los Reyes vs. De Leon, 11 SCRA 27 [1964].)*

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2. *Filing of foreclosure suit as equivalent to demand for payment.*

*Facts:* B obliged himself to pay S the balance of the purchase price of a subdivision lot within two years from completion by S of the roads in said subdivision. S brought action to foreclose the real estate mortgage executed by B to secure the payment of the unpaid price. B contends lack of previous notice of the completion of the roads and the absence of a demand for payment.

*Issue:* Is this contention of B tenable?

*Held:* No. The filing of the foreclosure suit by S is sufficient notice to S of the completion of the roads and of S's desire to be paid the purchase price. *(Enriquez vs. Ramos, 73 SCRA 116 [1976].)*

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3. *Buyer bound herself to pay the balance of the purchase price within a period of 10 years at a fixed monthly amortization.*

*Facts:* Petitioners CL (buyer) bound herself to pay HF (seller) P107,750.00 as the total price of the lot purchased: P10,775 shall be paid at the signing of the contract as downpayment, the balance of P96,975 shall be paid within a period of 10 years at a monthly amortization of P1,747.30 to begin from December 7, 1985 with interest at 18% *per annum* based on the balance and corresponding penalty in case of default.

CL failed to pay the installments after April 1, 1989. She claims, however, that the 10-year period for the payment of the whole purchase price has not yet elapsed.

*Issue:* Did CL incur in delay when she failed to pay the monthly amortizations?

*Held:* Yes. CL cannot ignore the provision on the payment of monthly installments by claiming that the 10-year period within which to pay has not elapsed.

HF performed his part of the obligation by allowing CL to continue in possession and use of the property. Clearly, when CL did not pay the monthly amortizations in accordance with the terms of the contract, she was in delay and liable for damages. However, the default committed by CL in respect of the obligation could be compensated by the interests and surcharges imposed upon her under the contract in question. *(Leaño vs. Court of Appeals, 369 SCRA 36 [2001].)*

## Effects of delay.

(1) *Mora solvendi.* — The following are the effects:

(a) The debtor is guilty of breach of the obligation;

(b) He is liable for interest in case of obligations to pay money (Art. 2209.) or damages in other obligations. (Art. 1170.) In the absence of extrajudicial demand, the interest shall commence from the filing of the complaint; and

(c) He is liable even for a fortuitous event when the obligation is to deliver a determinate thing. (Arts. 1165, 1170.) However, if the debtor can prove that the loss would have resulted just the same even if he had not been in default, the court may equitably mitigate the damages. (Art. 2215[4].)

In an obligation to deliver a generic thing, the debtor is not relieved from liability for loss due to a fortuitous event. He can still

be compelled to deliver a thing of the same kind (see Art. 1263.) or held liable for damages. (Art. 1170; see Lee vs. De Guzman, Jr., 187 SCRA 276 [1990].)

(2) *Mora accipiendi.* — The effects are as follows:

(a) The creditor is guilty of breach of obligation;

(b) He is liable for damages suffered, if any, by the debtor;

(c) He bears the risk of loss of the thing due (see Art. 1162.);

(d) Where the obligation is to pay money, the debtor is not liable for interest from the time of the creditor's delay; and

(e) The debtor may release himself from the obligation by the consignation of the thing or sum due. (see Art. 1256.)

(3) *Compensatio morae.* — The delay of the obligor cancels out the effects of the delay of the obligee and *vice versa*. The net result is that there is no actionable default on the part of both parties, such that as if neither one is guilty of delay.

If the delay of one party is followed by that of the other, the liability of the first infractor shall be equitably tempered or balanced by the courts. If it cannot be determined which of the parties is guilty of delay, the contract shall be deemed extinguished and each shall bear his own damages. (Art. 1192.)

**When demand not necessary to put debtor in delay.**

The general rule is that delay begins only from the moment the creditor demands, judicially or extrajudicially, the fulfillment of the obligation. The demand for performance marks the time when the obligor incurs *mora* or delay and is deemed to have violated his obligation. Without such demand, the effect of default will not arise unless any of the exceptions mentioned below is clearly proved.

(1) *When the obligation so provides.* —

EXAMPLE:

D promised to pay C the sum of P20,000.00 on or before November 30 without the need of any demand. Therefore, if D fails to pay on November 30, he is automatically in default. In this case, the parties stipulate to dispense with the demand.

The mere fixing of the period is not enough. The arrival of the period merely makes the obligation demandable. Before its arrival, the creditor cannot demand performance. The obligation must expressly so declare that demand is not necessary or must use words to that effect, as for instance, "the debtor will be in default" or "I will be liable for damages."

EXAMPLE:

The contract of loan between D and C provides that failure of D to pay any installment therein stipulated would mature the entire obligation. It does not state that in such an event, D shall thereafter be in default.

Demand is still necessary to hold D in default upon failure to pay any such installments. He is not liable for interest for default for the whole debt except from the time that judicial or extrajudicial demand for payment is made upon him. (see Quebar vs. Garduno and Martinez, 62 Phil. 879 [1936]; De los Reyes vs. De Leon, 11 SCRA 27 [1964].)

(2) *When the law so provides. —*

EXAMPLES:

(a) Under the law, taxes should be paid on or before a specific date; otherwise, penalties and surcharges are imposed without the need of demand for payment by the government.

(b) The partner is liable for the fruits of the thing he may have promised to contribute to the partnership from the time they should have been delivered without the need of any demand. (Art. 1786; see also Art. 1788.)

(3) *When time is of the essence. —*

EXAMPLES:

The delivery of balloons on a particular date when a children's party will be held; the making of a wedding dress where the wedding is scheduled at a certain time; payment of money at a particular time so that the creditor could pay off certain debts due on the same date; the delivery of a car to be used in a trip at a particular time; etc.

In all the foregoing cases, the debtor is fully aware that the performance of the obligation after the designated time would no longer benefit the creditor. When the time of delivery is not fixed or is stated in general and indefinite terms, time is not of the essence

of the contract. In such cases, the delivery must be made within a reasonable time, in the absence of anything to show that an immediate delivery was intended. (Smith, Bell & Co., Ltd. vs. Matti, 44 Phil. 874 [1922].) Even where time is of the essence, a breach of the contract in that respect by one of the parties may be waived by the other party's subsequently treating the contract as still in force. (Lorenzo Shipping Corp. vs. BJ Marthel International, Inc., 443 SCRA 163 [2004].)

ILLUSTRATIVE CASE:

*Prizes in a contest were not awarded on date specified, but winner did not make any demand.*

*Facts:* B (bank) started a contest of designs and plans for the construction of a building, announcing that the prizes would be awarded not later than November 30, 1921. C took part in the contest, performing work and incurring expenses for that purpose. B did not name judges and failed to award the prizes on the date specified.

C contended that the said date was the principal inducement in the creation of the obligation, because the current cost of concrete buildings at that time was fixed.

*Issue:* Was B in default in not awarding the prizes on November 30, 1921?

*Held:* No. The fixation of said price cannot be considered as the principal inducement of the contract for the contestants; neither was it for the bank, which could not be certain that said price would continue to be the current price when it desired to construct the building designed. There is no sufficient reason for considering that the date set for the award of the prizes was the principal inducement to the creation of the obligation.

The bank cannot be held in default through the mere lapse of time. There must be a demand, judicial or extrajudicial. *(De la Rosa vs. Bank of the Phil. Islands, 51 Phil. 926 [1928].)*

It is not necessary for the contract to categorically state that time is of the essence; intent is sufficient. (Hanlon vs. Hauserman, 40 Phil. 766 [1919].)

(4) *When demand would be useless.* —

EXAMPLE:

S obliged himself to deliver a specific horse to B on December 5. Through S's negligence or deliberate act, or by reason of a fortuitous

event for which S has expressly bound himself responsible (see Art. 1174.), the horse died on December 2.

Under this situation, any demand for the delivery of the horse on December 5 would be useless as S has made it impossible for him to perform his obligation.

Demand is also unnecessary where it is apparent that it would be unavailing, as where there has been a prior absolute refusal by S (see 13 C.J. 661.) or S has manifested an intention not to comply with his obligation.

(5) *When there is performance by a party in reciprocal obligations.* — In case of reciprocal obligations (see Art. 1191.), the performance of one is conditioned upon the simultaneous fulfillment on the part of the other.

(a) So neither party incurs in delay if the other does not comply or is not ready to comply in a proper manner with what is incumbent upon him. (Art. 11699, last par.) This is *compensatio morae.* Thus, where the contract of sale imposes on the seller the obligation to deliver to the buyer a reasonably habitable dwelling in return for his undertaking to pay the stipulated price in monthly amortizations, the seller cannot invoke the buyer's suspension of payment of amortizations as cause to cancel the contract where the seller did not fulfill its obligation and is not willing to put the house in habitable state. (Agcaoili vs. GSIS, 165 SCRA 1 [1988].)

(b) From the moment a party in reciprocal obligations fulfills or is ready to fulfill his obligation, delay by the other begins. Where the parties fix a period for the performance of their reciprocal obligations, neither party can demand performance nor incur in delay before the expiration of the period. (Abesamis vs. Woodcraft Works, Ltd., 30 SCRA 372 [1969].) The parties may provide different dates for performance of their respective obligations.

(c) Obligations under an *option to buy* (see Art. 1324.) are reciprocal obligations, *i.e.,* the payment of the purchase price by the would-be buyer is contingent upon the execution of the deed of sale by the owner of the property; hence, notice to the latter of the former's decision to exercise his option to buy and readiness to pay the price need not be coupled with actual payment thereof and since the obligation is not yet due, consignation in court (Art. 1256.) of the purchase price is not required. (Heirs of Luis Bacus vs. Court of Appeals, 371 SCRA 295 [2001].)

ILLUSTRATIVE CASES:

1. *Payment of purchase price is conditioned upon conveyance by all the co-owners of their entire interest in the property sold.*

*Facts:* S sold to B a piece of land owned by her in common with the understanding that S was to procure the conveyance and also the interests of her co-owners. B refused to make further payments of the purchase price because of S's failure to procure that conveyance of the entire estate to B.

After some years, S became the owner of the whole estate. In view of its increased value, S brought action for rescission.

*Issue:* Has S the right to rescind the contract on the ground that B has failed to pay the purchase price?

*Held:* No. The failure of B to pay was due to S's failure to convey to him the interests in the whole land and, therefore, he should not be deemed to have been in default. The contract entailed mutual obligations, and if either party can be said to have been in default it was S rather than B. The contract contemplated a conveyance of the entire interest in the land and S clearly obligated herself to that extent.

S was, therefore, not in position to compel B to pay until she could offer to him a deed sufficient to pass the whole legal estate; and for the same reason, to rescind the contract on the ground that B failed to pay the purchase price. *(Causing vs. Bencer, 37 Phil. 417 [1918].)*

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2. *Payment of purchase price is conditioned upon grant by seller to buyer of authority to sell or mortgage the property seller agreed to convey.*

*Facts:* S agreed to convey to B a 36% share in two parcels of land upon payment of P35,000.00 and to authorize B to sell or mortgage the said 36% interest for the purpose of raising the P35,000.00 within 70 days from the date of the agreement. It was stipulated that should B fail to pay the P35,000.00 within the 70-day period fixed, S would automatically be the owner of the 36% interest in the properties.

B failed to pay the P35,000.00 within the 70-day period. He alleges that his inability was due to the refusal of S to grant the authority to sell or mortgage the 36% of the properties.

*Issue:* Without the authority in question did the obligation of B to pay S mature?

*Held:* No. The stipulation has established reciprocal obligations between the parties. The sequence in which they are to be performed is quite clear. The giving of the authority to sell or mortgage precedes

the obligation of B to pay P35,000.00. *(Martinez vs. Cavives, 25 Phil. 581 [1913].)* Without the authority, the 70-day period for payment did not commence to run. From the very nature of the obligation assumed by S, demand by B that it be performed was not necessary. (Art. 1169, par. 2.)

In this case, S was ordered to execute in favor of B the proper authority to sell or mortgage within 30 days from notice of the decision and B to pay S P35,000.00 within 30 days from the date such authority is granted. *(Rodriguez vs. Belgica, 1 SCRA 611 [1961].)*

**When time of the essence even without express stipulation.**

It is not necessary, in order to make time of the essence of a contract, that the contract should expressly so declare. Words of this import need not be used. It is sufficient that the intention to this effect should appear, and there are certain situations wherein it is held, from the nature of the agreement itself, that time is of the essence of the contract.

Time may be of the essence, without express stipulation to that effect by implication from the nature of the contract itself, of the subject matter, or of the circumstances under which the contract is made. (36 Cyc. 709.)

(1) In agreements which are executed in the form of options, time is always held to be of the essence of the contract, and it is well recognized that in such contracts, acceptance of the option and payment of the purchase price constitute conditions precedent to specific performance. (*Ibid.,* 711.)

(2) The same is true generally of all unilateral contracts. *(Ibid.)*

(3) In mercantile contracts for the manufacture and sale of goods, time is also held to be of the essence of the agreement. (13 C.J. 688.)

(4) Likewise, where the subject matter of a contract is of speculative or fluctuating value, it is held that the parties must have intended time to be of the essence. *(Ibid.)*

(5) Most conspicuous among all the situations where time is presumed to be of the essence of a contract from the very nature of the subject-matter is that where the contract relates to mining property. As has been well said by the Supreme Court of the United States, such property requires, and of all properties perhaps the most requires, the persons interested in it to be vigilant and active in asserting their

rights. (Waterman vs. Banks, 144 U.S. 394, 36 L. Ed., 479, 483.) Hence, it is uniformly held that time is of the essence of the contract in the case of an option on mining property, or a contract for the sale thereof, even though there is no express stipulation to that effect. (27 Cyc., 675, cited in Hanlon vs. Hausserman, 40 Phil. 796 [1919].)

**ART. 1170. Those who in the performance of their obligations are guilty of fraud, negligence, or delay, and those who in any manner contravene the tenor thereof, are liable for damages. (1101)**

## Grounds for liability.

Article 1170 gives the four grounds for liability which may entitle the injured party to damages (see Art. 2197.) for all kinds of obligations regardless of their source, mentioned in Article 1157, whether the obligations are real or personal. *(supra.)* It contemplates that the obligation was eventually performed but the obligor is guilty of breach thereof. Here, the breach of the obligation is voluntary; in Article 1174, it is involuntary.

(1) *Fraud (deceit or dolo).* — As used in Article 1170, it is the deliberate or intentional evasion of the normal fulfillment of an obligation. (see 8 Manresa 72.)

(a) As a ground for damages, it implies some kind of malice or dishonesty and it cannot cover cases of mistake and errors of judgment made in good faith. It is synonymous to bad faith in that it involves a design to mislead or deceive another.[6] (O'leary Macondray & Co., 45 Phil. 812 [1924]; Solid Bank Corp. vs. Mindanao Ferroalloy Corp., 464 SCRA 409 [2005].) Moral damages may be recovered in addition to other damages. (see Art. 2220; Far East Bank & Trust Co. vs. Court of Appeals, 241 SCRA 671 [1995].)

(b) Article 1170 refers to *incidental fraud (dolo incidente)* committed in the performance of an obligation already existing because of contract. It is to be differentiated from *causal fraud (dolo*

[6]Bad faith does not simply connote bad judgment or negligence; it imports a dishonest purpose or some moral obliquity and conscious doing of a wrong, a breach of a known duty through some motive or interest or ill-will that partakes of the nature of fraud. Bad faith and fraud are allegations of a fact that demand clear and convincing proof. (Cathay Pacific Airways, Ltd. vs. Vasquez, 399 SCRA 207 [2003].) It is good faith, not bad faith, which is presumed.

*causante)* or fraud employed in the execution of a contract under Article 1338, which vitiates consent and makes the contract voidable and to incidental fraud under Article 1344 also employed for the purpose of securing the consent of the other party to enter into the contract but such fraud was not the principal inducement to the making of the contract.

(c) Under Article 1170, the fraud is employed for the purpose of evading the normal fulfillment of an obligation and its existence merely results in breach thereof giving rise to a right by the innocent party to recover damages. The Civil Code refers to *civil fraud*. *Criminal fraud* gives rise to criminal liability.

EXAMPLE:

S obliged himself to deliver to B 20 bottles of wine, of a particular brand. S delivered 20 bottles knowing that they contain cheaper wine. S is guilty of fraud and is liable for damages to B.

If B bought the 20 bottles of wine on the false representation of S that the wine is that as represented by the labels, the fraud committed by S is causal fraud. Without the fraud, B would not have given his consent to the contract. He has the right to have the contract annulled or set aside on the ground of the fraud. (Arts. 1390, 1391.)

In the first situation, the remedy of B is not annulment of the contract of sale which is not affected by the incidental fraud but to claim damages. If the fraud employed by S to get B's consent was not the principal inducement that led B to enter into the contract, the fraud is also incidental under Article 1344 and it will likewise give rise only to an action for damages. (see Art. 1344, par. 2.)

ILLUSTRATIVE CASE:

*Liability of a party authorized by another to exercise discretion, for honest mistakes or errors of judgment.*

*Facts:* C, contractor, brought action to recover the actual costs of the construction of the building of B, plus 12-1/2% for and on account of his services and superintendence of the building, as per contract. B alleged that through C's negligence in the construction of the building and the purchase of materials, B suffered damages.

B's counterclaims are founded upon C's mistakes and errors of judgment in the employment of labor and the purchase of materials.

*Issue:* Assuming that there were such mistakes or errors of judgment, would C be liable for them under the contract?

*Held:* No. The fact that the price of lumber or of labor went up or down, or was cheaper at a certain time, would not make C liable for a breach of contract, so long as he was exercising his best judgment and acting in good faith. Under the contract, the materials were to be purchased by C "in such quantities and at such times as may appear to be to your [B's] interest." This vested in C a discretionary power as to the time and manner for the purchase of materials.

The same thing is true as to the employment of labor. While it is true that the contract recites that time is an important provision, it does not say, however, when the building is to be completed or that time is of the essence of the contract. In other words, under the terms of the contract, the employment of labor, the purchase of materials, and the construction and completion of the building were all matters which were largely left to the discretion of C, for which he should not be held liable for honest mistakes or errors of judgment. *(O'leary vs. Macondray & Co., 45 Phil. 812 [1924].)*

(2) *Negligence (fault or culpa).* — It is any voluntary act or omission, there being no malice, which prevents the normal fulfillment of an obligation.[7] (see Arts. 1173, 1174.)

(3) *Delay (mora).* — This has already been discussed under Article 1169 which determines the commencement of delay. It has been ruled that the delay in the performance of the obligation under Article 1170 must be either malicious or negligent. Thus, where the omission of the buyer to sign a check, one of 24 post dated checks which were delivered to the seller who did not bother to call the buyer to ask him to sign the check, was mere "inadvertence" on the part of the buyer, the latter was held not liable for damages resulting from the delay in the payment of the value of the unsigned check. (Rizal Commercial Banking Corp. vs. Court of Appeals, 305 SCRA 449 [1999].)

(4) *Contravention of the terms of the obligation.* — This is the violation of the terms and conditions stipulated in the obligation. The contravention must not be due to a fortuitous event or *force majeure.* (Art. 1174.) The unilateral act of terminating a contract without legal

[7]The act of a bank of allowing complete strangers to take possession of the owner's duplicate certificate of title entrusted to it even if the purpose is merely for photo copying constitutes manifest negligence which would hold it liable for damages to those contractually and legally entitled to its possession, under Article 1170 and other relevant provisions of the Civil Code. (Heirs of E. Manlapat vs. Court of Appeals, 459 SCRA 412 [2005].)

justification by a party makes him liable for damages suffered by the other pursuant to Article 1170. (Pacmac, Inc. vs. Intermediate Appellate Court, 150 SCRA 555 [1987].)

**Recovery of damages for breach of contract or obligation.**

*Breach of contract* is the failure without justifiable excuse to comply with the terms of a contract. The breach may be willful or done unintentionally. It has been defined as the failure, without legal excuse, to perform any promise which forms the whole or part of the contract. (Nakpil vs. Manila Towers Dev. Corp., 502 SCRA 470 [2006].)

(1) *Measure of recoverable damages.* — The provisions under Title XVIII on "Damages" of the Civil Code govern in determining the measure of recoverable damages.[8] Fundamental in the law on damages is that one injured by a breach of a contract, or by a wrongful or negligent act or omission shall have a fair and just compensation commensurate to the loss sustained as a consequence of the defendant's act. (Llorente, Jr. vs. Sandiganbayan, 287 SCRA 382 [1998].)

(2) *Contractual interests of obligee or promisee, remedy serves to preserve.* — A breach upon the contract confers upon the injured party a valid cause for recovering that which may have been lost or suffered. The remedy serves to preserve the interests of the promisee that may include:

(a) *Expectation interest*, which is his interest in having the benefit of his bargain by being put in as good a position as he would have been had the contract been performed; or

(b) *Reliance interest*, which is his interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as he would have been had the contract not been made; or

(c) *Restitution interest*, which is his interest in having restored to him any benefit that he has conferred on the other party. (FGU Insurance Corp. vs. G.P. Sarmiento Trucking Corp., 386 SCRA 312 [2002].)

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[8]The award of the different kinds of damages cannot be lumped together (*e.g.*, to pay plaintiff actual, moral and exemplary damages in the amount of P100,000). The damages as well as attorney's fees must each be independently identified and justified. (Herbosa vs. Court of Appeals, 374 SCRA 578 [2002].)

(3) *Excuse from ensuing liability.* — The effect of every infraction is to create a new duty, that is, to make recompense to the one who has been injured by the failure of another to observe his contractual obligation. The mere proof of the existence of the contract and the failure of its compliance justify a corresponding right of relief to the obligee unless the obligor can show extenuating circumstance, like proof of his exercise of due diligence (normally that of the diligence of a good father of a family or, exceptionally by stipulation or by law such as in the case of common carriers, that of extraordinary diligence) or of the attendance of fortuitous event, to excuse him from his ensuing liability. *(Ibid.)*

(4) *Duty of obligee to minimize his damages.* — An obligee is duty bound to minimize the damages for which he intends to hold any obligor responsible. (see Art. 2203.) He cannot recover damages for any loss which he might have avoided with ordinary care. If his negligence was contributory to the loss, the court may equitably mitigate the damages. *(infra.)*

The duty to minimize his damages as much as possible is imposed by law upon the claimant, regardless of the unquestionability of his entitlement thereto. Such indeed is the demand of equity, for the juridical concept of damages is nothing more than to repair what has been lost materially and morally. It may not be taken advantage of to allow unjust enrichment. (Lina vs. Purisima, 82 SCRA 344 [1978].)

**Damages recoverable where obligation to pay money.**

(1) *Penalty interest for delay or non-performance.* — Damages may be recovered under Article 1170 when the obligation is to do something other than the payment of money but when the obligation which the debtor failed to perform consists only in the payment of money, the rule of damages is that laid down in Article 2209 of the Civil Code. (Quiros vs. Tan-Guinlay, 5 Phil. 675 [1906]; Talisay Silay Milling Co., Inc. vs. Court of Industrial Relations, 4 SCRA 1009 [1962].) Said article is as follows:

> "If the obligation consists in the payment of a sum of money, and the debtor incurs in delay, the indemnity for damages, there being no stipulation to the contrary shall be the payment of the interest agreed upon, and in the absence of stipulation, the legal interest, which is six per cent *per annum.* (1108)"

The damage dues (or penalty interest) do not include and are not included in the computation of interest as the two are distinct claims which may be demanded separately. While interest agreed upon forms part of the consideration of the contract itself, damage dues are usually made payable only in case of default or non-performance of the contract. (Sentinel Insurance Co., Inc. vs. Court of Appeals, 182 SCRA 516 [1990].)

(2) *Rate of the penalty interest.* — The rate of the penalty interest payable shall be that agreed upon. In the absence of stipulation of a particular rate of penalty interest, then the additional interest shall be at a rate equal to the regular monetary interest; and if no regular interest had been agreed upon, then the legal interest shall be paid. The payment of the regular interest constitutes the price or cost of the use of money and thus, until the principal due is returned to the creditor, such interest continues to accrue since the debtor continues to use such principal amount. (State Investment House, Inc. vs. Court of Appeals, 198 SCRA 390 [1991].)

*Note:* By virtue of the authority granted to it under Section 1 of Act No. 2655, as amended, otherwise known as the "Usury Law," the Monetary Board, in its Resolution No. 1622, dated July 29, 1974, has prescribed that the rate of interest for the *loan* or *forbearance* of any money, goods or credits and the rate allowed in judgments, in the absence of express contract as to such rate of interest, shall be 12% *per annum*.[9] (C.B. Circ. No. 416, July 29, 1974.)

**Fraud and negligence distinguished.**

Fraud may be distinguished from negligence as follows:

(1) In fraud, there is deliberate intention to cause damage or injury, while in negligence, there is no such intention;

(2) Waiver of the liability for future fraud is void (Art. 1171.), while such waiver may, in a certain sense, be allowed in negligence;

(3) Fraud must be clearly proved, mere preponderance of evidence not being sufficient, while negligence is presumed from the breach of a contractual obligation; and

[9]See "Liability for legal interest" under Article 1175 when an obligation, whether it consists or not in the payment of money, is breached.

(4) Lastly, liability for fraud cannot be mitigated by the courts, while liability for negligence may be reduced according to the circumstances. (Art. 1173.)

They are similar in that both are voluntary, that is, they are committed with volition but in fraud, a party, by his voluntary execution of a wrongful act, or a willful omission, knows and intends the effects which naturally and necessarily arise from such act or omission which deliberate intent is lacking in negligence. (Legaspi Oil Co., Inc. vs. Court of Appeals, 224 SCRA 213 [1993]; International Corporate Bank vs. Gueco, 351 SCRA 516 [2001].) It being a state of the mind, fraud may be inferred from the circumstances of the case.

### When negligence equivalent to fraud.

Where the negligence shows bad faith or is so gross that it amounts to malice or wanton attitude on the part of the defendant, the rules on fraud shall apply. (see Art. 1173.) In such case, no more distinction exists between the two at least as to effects.

*Gross negligence* is negligence characterized by want or absence of or failure to exercise even slight care or diligence, or the entire absence of care, acting or omitting to act on a situation where there is a duty to act, not inadvertently but willfully and intentionally.

It evinces a thoughtless disregard of or conscious indifferences to consequences insofar as other persons may be affected, without exerting any effort to avoid them. (Judy Philippines, Inc. vs. National Labor Relations Commission, 289 SCRA 755 [1998]; Evangelista vs. People, 315 SCRA 525 [1999]; Macalinao vs. Ong, 477 SCRA 740 [2006]; Ilao-Oreta vs. Ronquillo, 535 SCRA 633 [2007]; Hao vs. Andres, 555 SCRA 8 [2008].)

**ART. 1171. Responsibility arising from fraud is demandable in all obligations. Any waiver of an action for future fraud is void. (1102a)**

### Responsibility arising from fraud demandable.

This article refers to incidental fraud which is employed in the fulfillment of an obligation. (Art. 1170.)

Responsibility arising from fraud can be demanded with respect to all kinds of obligation and unlike in the case of responsibility arising from negligence (Art. 1172.), the court is not given the power to mitigate or reduce the damages to be awarded. This is so because fraud is deemed serious and evil that its employment to avoid the fulfillment of one's obligation should be discouraged.

**Waiver of action for future fraud void.**

According to the time of commission, fraud may be past or future.

A waiver of an action for future fraud is void (no effect, as if there is no waiver) as being against the law and public policy. (Art. 1409[1].) A contrary rule would encourage the perpetration of fraud because the obligor knows that even if he should commit fraud he would not be liable for it thus making the obligation illusory.

**Waiver of action for past fraud valid.**

What the law prohibits is waiver anterior to the fraud and to the knowledge thereof by the aggrieved party.

A past fraud can be the subject of a valid waiver because the waiver can be considered as an act of generosity and magnanimity on the part of the party who is the victim of the fraud. Here, what is renounced is the effects of the fraud, that is, the right to indemnity of the party entitled thereto.

**ART. 1172. Responsibility arising from negligence in the performance of every kind of obligation is also demandable, but such liability may be regulated by the courts, according to the circumstances. (1103)**

**Responsibility arising from negligence demandable.**

(1) In the performance of every kind of obligation, the debtor is also liable for damages resulting from his negligence or *culpa*. The courts, however, are given wide discretion in fixing the measure of damages. The reason is because negligence is a question which must necessarily depend upon the circumstances of each particular case. Moreover, negligence is not as serious as fraud because in the case of the former, there is no bad faith or deliberate intention to cause injury or damages. The courts, however, may increase the damages.

(2) When both parties to a transaction are mutually negligent in the performance of their obligations, the fault of one cancels the negligence of the other. Thus, their rights and obligations may be determined equitably under the law prescribing unjust enrichment. No one shall enrich himself at the expense of another. (Rodzssen Supply, Inc. vs. Far East Bank & Trust Co., 357 SCRA 618 [2001]; Remington Industrial Sales Corp. vs. Chinese Young Men's Christian Assoc., 531 SCRA 750 [2007]; see Arts. 1160, 1192.)

**Validity of waiver of action arising from negligence.**

(1) An action for future negligence (not fraud) may be renounced except where the nature of the obligation requires the exercise of extraordinary diligence as in the case of common carriers. (see Art. 1733.)

(2) Where negligence is gross or shows bad faith, it is considered equivalent to fraud. Bad faith does not simply connote negligence or bad judgment causing damages to another. Any waiver of an action for future negligence of this kind is, therefore, void.

**Kinds of negligence according to source of obligation.**

*Culpa* or negligence may be understood in three different senses. They are:

(1) *Contractual negligence (culpa contractual)* or negligence in contracts resulting in their breach Article 1172 refers to *"culpa contractual."* This kind of negligence is not a source of obligation. (Art. 1157.) It merely makes the debtor liable for damages in view of his negligence in the fulfillment of a pre-existing obligation resulting in its breach or non-fulfillment. (Arts. 1170-1174, 2201.) It is a kind of civil negligence if it does not amount to a crime;

(2) *Civil negligence (culpa aquiliana)* or negligence which by itself is the source of an obligation between the parties not formally bound before by any pre-existing contract. It is also called "tort" or "quasi-delict." (Art. 2176.[10]);

[10]Article 2176 (see Note 1 under Art. 1162, Chap. 1.) covers not only acts committed with negligence, but also acts which are voluntary and intentional. (Dulay vs. Court of Appeals, 243 SCRA 220 [1995].)

A pre-existing contractual relation between the parties does not, however, preclude the existence of *culpa aquiliana.* (Syquia vs. Court of Appeals, 217 SCRA 614 [1993].) A quasi-delict can be the cause for breaching a contract that might thereby permit the application of governing principles of tort even when there is a pre-existing contract between the parties. This rule, however, governs only where the act or omission complained of would constitute an actionable tort independently of the contract (Far East Bank & Trust Co. vs. Court of Appeals, 241 SCRA 671 [1995].); and

(3) *Criminal negligence (culpa criminal)* or negligence resulting in the commission of a crime. (Arts. 3, 365, Revised Penal Code.) The same negligent act causing damages may produce civil liability arising from a crime under Article 100 of the Revised Penal Code *(supra.)*, or create an action for quasi-delict under Article 2176, *et seq.*, of the Civil Code. (see Barredo vs. Garcia and Almario, 73 Phil. 607 [1942]; Elcano vs. Hill, 77 SCRA 98 [1977].)

In negligence cases, the aggrieved party may choose between a criminal action under Article 100 of the Revised Penal Code or a civil action for damages under Article 2176 of the Civil Code. What is prohibited under Article 2177 of the Civil Code is to recover twice for the same negligent act. (Virata vs. Ochoa, 81 SCRA 472 [1978].)

EXAMPLES:

(1) If S entered into a contract of sale with B to deliver a specific horse on a certain day and the horse died through the negligence of S before delivery, S is liable for damages to B for having failed to fulfill a pre-existing obligation (contract may be either express or implied) because of his negligence. This is *culpa contractual.*

(2) Assume now, that the horse belongs to and is in the possession of B. The negligence of S which results in the death of the horse is *culpa aquiliana.* In this case, there is no pre-existing contractual relation between S and B. The negligence itself is the source of liability. (Art. 1157[5].)

(3) A crime can be committed by negligence. If B wants, he can bring an action for *culpa criminal* (damage to property through simple or reckless imprudence). Here, the crime is the source of the obligation of S to pay damages. (Arts. 1157[4], 1161.)

But B cannot recover damages twice for the same act or omission of S. In other words, responsibility for quasi-delict is not demandable together with the civil liability arising from a criminal offense. (Art. 2177.)

**Importance of distinction between *culpa contractual* and *culpa aquiliana*.**

The distinction between the first two kinds of negligence is important in our jurisdiction.

Where liability arises from a mere tort *(culpa aquiliana),* not involving a breach of positive obligation, an employer or master may excuse himself under the last paragraph of Article 2180[11] by proving that he had exercised "all the diligence of a good father of a family to prevent the damage." It is a complete defense.

This defense is not available if the liability of the employer or master arises from a breach of contractual duty *(culpa contractual)* though this may mitigate damages. (Del Prado vs. Manila Electric Co., 51 Phil. 900 [1928]; Cangco vs. Manila Railroad Co., 38 Phil. 769 [1918]; De Guia vs. Manila Electric Railroad and Light Co., 40 Phil. 706 [1920].) It has been held that where the injury is due to the concurrent negligence of the drivers of the colliding vehicles, the drivers and owners of the said vehicles shall be primarily, directly and solidarily liable for damages and it is immaterial that one action is based on quasi-delict and the other on *culpa contractual* as the solidarity of the obligation (see Art. 1207.) is justified by the very nature thereof.[12] (Metro Manila Transit Corp. vs. Court of Appeals, 223 SCRA 521 [1993].)

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[11]See Note 3, under Article 1162, Chapter 1.

Article 2180 in relation to Article 2176 of the Civil Code provides that the employer of a negligent employee is liable for the damages caused by the latter. When an injury is caused by the negligence (quasi-delict) of an employee there instantly arises a presumption of the law that there was negligence on the part of the employer either in the selection of his employee or in the supervision over him after such selection. (Baliwag Transit, Inc. vs. Court of Appeals, 262 SCRA 230 [1996].)

[12]In *culpa contractual*, the mere proof of the existence of the contract and the failure of its compliance justify, *prima facie*, a corresponding right of relief. In a contract of carriage, the driver who is not a party to the contract, may not be held liable under the agreement. The action against him can only be based on *culpa aquiliana*, which unlike *culpa contractual*, would require the claimant for damages to prove negligence or fault on the part of the defendant. (FGU Insurance Corporation vs. G.P. Sarmiento Trucking Corporation, 386 SCRA 312 [2002].) In an action based on a breach of contract of carriage, the aggrieved party does not have to prove that the common carrier was at fault or was negligent. (China Airlines, Ltd. vs. Court of Appeals, 406 SCRA 113 [2003].) In *culpa aquilina*, the plaintiff has the burden of proving that the defendant was at fault or negligent while in *culpa contractual*, once the plaintiff proves a breach of contract, there is a presumption that the defendant was at fault or negligent. Unlike in the first, the defense of exercising the required diligence in the selection and supervision of employees is not a complete defense in the second. (Consolidated Bank and Trust Corporation vs. Court of Appeals, 410 SCRA 562 [2003].)

**Effect of negligence on the part of the injured party.**

Suppose the creditor is also guilty of negligence, can he recover damages?

Article 2179 of the Civil Code provides:

> "When the plaintiff's own negligence was the immediate and proximate cause of his injury, he cannot recover damages. But if his negligence was only contributory, the immediate and proximate cause of the injury being the defendant's lack of due care, the plaintiff may recover damages, but the courts shall mitigate the damages to be awarded." (see Arts. 2214, 2215.[13])

In other words, to be entitled to damages, the law does not require that the negligence of the defendant should be the sole cause of the damage. (Astudillo vs. Manila Electric Co., 55 Phil. 427 [1930].) There is contributory negligence on the part of the injured party where his conduct has contributed, as a legal cause to the harm he has suffered, which falls below the standard to which he is required to conform for his own protection. (Valenzuela vs. Court of Appeals, 253 SCRA 303 [1996].) The defense of contributory negligence of the injured party does not apply in criminal cases where the offense was committed by the accused through reckless imprudence since one cannot allege the negligence of another (*e.g.*, deceased was driving with an expired license) to evade the effects of his own negligence. (Genobiagon vs. Court of Appeals, 504 SCRA 354 [2006].)

**Presumption of contractual negligence.**

(1) In an action for quasi-delict or tort, the negligence or fault should be clearly established because it is the basis of the action,

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[13]Art. 2214. In quasi-delicts, the contributory negligence of the plaintiff shall reduce the damages that he may recover.

Art. 2215. In contracts, quasi-contracts, and quasi-delicts, the court may equitably mitigate the damages under circumstances other than the case referred to in the preceding article, as in the following instances:

(1) That the plaintiff himself has contravened the terms of the contract;

(2) That the plaintiff has derived some benefit as a result of the contract;

(3) In cases where exemplary damages are to be awarded, that the defendant acted upon the advice of counsel;

(4) That the loss would have resulted in any event;

(5) That since the filing of the action, the defendant has done his best to lessen the plaintiff's loss or injury.

whereas in a breach of contract, the action can be pursued by proving the existence of the contract, and the fact that the obligor failed to comply with the same.

(2) When the action is based on a contract of carriage, and the obligor, in this case the carrier, failed to transport the passenger to his destination, the fault or negligence of the carrier is presumed. It is sufficient for the plaintiff to prove the existence of the contract of carriage and the damages or injuries suffered by him. It is the obligation of the carrier to transport its passengers or goods safely. (see San Pedro Bus Lines vs. Navarro, 94 Phil. 846 [1954]; Davila vs. Phil. Air Lines, 21 SCRA 642 [1972]; Roque vs. Buan, 21 SCRA 642 [1967]; Calalas vs. Court of Appeals, 332 SCRA 356 [2000]; DSR-Senator Lines vs. Federal Phoenix Assur. Co., Inc., 413 SCRA 14 [2003].)

(a) The driver's negligence is the carrier's. Hence, in *culpa contractual*, the moment a passenger dies or is injured, the common carrier is presumed to have been at fault or to have acted negligently, and the disputable presumption may only be overcome by evidence that he had exercised extraordinary diligence as prescribed in Articles 1733, 1755, and 1756 of Civil Code or that the death or injury of the passenger was due to a fortuitous event. However, the presumption of fault or negligence will not arise if the loss is due to any of the causes enumerated in Article 1734[14] of the Civil Code. This is a closed list. If the cause of destruction, loss or deterioration of goods transported is other than the enumerated circumstances, then the carrier is liable therefor. (Belgian Overseas Chartering and Shipping N.V. vs. Phil. First Insurance Co., Inc., 383 SCRA 23 [2002].)

(b) The driver is not solidarily liable (see Arts. 1207, 1208.) with the carrier, the latter being exclusively responsible to the passenger without the right of the carrier to recover from his driver for the latter's negligence. (Phil. Rabbit Bus Lines, Inc. vs. Intermediate Appellate Court, 189 SCRA 158 [1990].)

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[14]Art. 1734. Common carriers are responsible for the loss, destruction, or deterioration of the goods, unless the same is due to any of the following causes only:

1. Flood, storm, earthquake, lightning, or other natural disaster or calamity;
2. Act of the public enemy in war, whether international or civil;
3. Act or omission of the shipper or owner of the goods;
4. The character of the goods or defects in the packing or in the containers;
5. Order or act of competent public authority.

**ART. 1173. The fault or negligence of the obligor consists in the omission of that diligence which is required by the nature of the obligation and corresponds with the circumstances of the persons, of the time and of the place. When negligence shows bad faith, the provisions of Articles 1171 and 2201, paragraph 2, shall apply.**

**If the law or contract does not state the diligence which is to be observed in the performance, that which is expected of a good father of a family shall be required. (1104a)**

### Meaning of fault or negligence.

(1) *Fault* or negligence is defined by the above provision. (par. 1.)

(2) According to our Supreme Court, "negligence is conduct that creates undue risk or harm to another. It is the failure to observe for the protection of the interests of another person, that degree of care, precaution and vigilance which the circumstances justly demand, whereby such other person suffers injury."[15] (United States vs. Barrias, 23 Phil. 434 [1912], adopting the definition given by Judge Cooley; Jarco Marketing Corporation vs. Court of Appeals, 321 SCRA 375 [1999].) It is "the want of care required by the circumstances." (Cortes vs. Manila Railroad Company, 27 SCRA 674 [1969]; Valenzuela vs. Court of Appeals, 253 SCRA 303 [1996]; Smith Bell Dodwell Shipping Agency Corp. vs. Borja, 383 SCRA 341 [2002].)

### Test for determining whether a person is negligent.

(1) *Reasonable care and caution expected of an ordinary prudent person.* — "The test for determining whether a person is negligent in doing an act whereby injury or damage results to the person or property of another is this: Would a prudent man, in the position of the person to whom negligence is attributed, foresee harm to the person injured as a

[15] "An accident pertains to an unforeseen event in which no fault or negligence attaches to the defendant. It is "a fortuitous circumstance, event or happening; an event happening without any human agency, or if happening wholly or partly through human agency, an event which under the circumstances is unusual or unexpected by the person to whom it happens. x x x Accident and negligence are intrinsically contradictory; one cannot exist with the other. Accident occurs when the person concerned is exercising ordinary care, which is not caused by fault of any person and which could not have been prevented by any means suggested by common prudence." (Jarco Marketing Corporation vs. Court of Appeals, 321 SCRA 375 [1999]; People vs. Fallouna, 424 SCRA 655 [2004].)

reasonable consequence of the course about to the pursued? If so, the law imposes the duty on the actor to refrain from that course or to take precaution against its mischievous results, and the failure two do so constitutes negligence. Reasonable foresight of harm followed by the ignoring of the admonition born of this provision, is the constitutive fact of negligence." (Picart vs. Smith, 37 Phil. 809 [1918].)

Simply stated: "Did the defendant in doing the alleged negligent act use the reasonable care and caution which an ordinary prudent person would have used in the same situation. If not, then he is guilty of negligence." (Mandarin Villa, Inc. vs. Court of Appeals, 257 SCRA 538 [1996]; Jarco Marketing Corp. vs. Court of Appeals, *supra*.)

(2) *No hard and fast rule for measuring degree of care.* — By such a test, it can readily be seen that there is no hard and fast rule whereby the degree of care and vigilance required is measured. It is dependent upon the circumstances in which a person finds himself situated. All that the law requires is that it is always incumbent upon a person to use that care and diligence expected of prudent and reasonable men under similar circumstances. (Cusi vs. Phil. National Railways, 90 SCRA 357 [1979]; see Illusorio vs. Court of Appeals, 393 SCRA 89 [2002]; Phil. National Railways vs. Court of Appeals, 536 SCRA 147 [2007].)

In other words, the existence of negligence in a given case is not determined by reference to the personal judgment of the actor in the situation before him. It is the law that considers what would be reckless or negligent in the man of ordinary intelligence and determines liability by that. (Layugan vs. Intermediate Court, 107 SCRA 363 [1988].)

**Factors to be considered.**

Negligence is a question of fact, its existence being dependent upon the particular circumstances of each case. It is never presumed but must be proven by the party who alleges it. In determining the issue of negligence where loss or damage occurs, the following factors must be considered:

(1) *Nature of the obligation. — e.g.,* smoking while carrying materials known to be inflammable constitutes negligence;

(2) *Circumstances of the person. — e.g.,* a guard, a man in the prime of life, robust and healthy, sleeping while on duty is guilty of negligence;

(3) *Circumstances of time. — e.g.,* driving a car without headlights

at night is gross negligence but it does not by itself constitute negligence when driving during the day; and

(4) *Circumstances of the place. — e.g.*, driving at 60 kilometers per hour on the highway is permissible but driving at the same rate of speed in Quezon Boulevard, Manila, when traffic is always heavy is gross recklessness.

When the source of an obligation is derived from a contract, the mere breach or non-fulfillment of the prestation gives rise to the presumption of fault on the part of the obligor. (Sabena Belgian World Airlines vs. Court of Appeals, 255 SCRA 38 [1996].)

ILLUSTRATIVE CASES:

1. *Negligence in the care of goods.*

*Facts:* S discharged a large shipment of potatoes belonging to B into a lorcha which was then left for two days in the sun tightly closed and without ventilation. As a result, the potatoes rotted and became useless.

*Issue:* Is S liable for the loss?

*Held:* Yes. S was guilty of gross negligence with respect to the care of the potatoes, a perishable property. (*Haskim & Co. vs. Rocha & Co.*, 18 Phil. 315 [1911]; see Tan Chiong Sian vs. Inchausti & Co., 22 Phil. 152 [1912].)

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2. *Negligence in not giving previous warning against a dangerous machine.*

*Facts:* R employed a young ignorant boy to do ordinary chores in the performance of which he did not come in contact with machinery. Without giving any previous warning, and over the objections of the boy, the latter was ordered to assist in the cleaning of a dangerous machine. His fingers were cut in the machine.

*Issue:* Is R liable for damages?

*Held:* Yes. It was negligence on his part not to warn the boy and give him instructions to avoid accidents in the cleaning of a machine with which the boy was unfamiliar. *(Tamayo vs. Gsell, 35 Phil. 953 [1916].)*

**Measure of liability for damages.**

(1) *Civil Code provisions.* — The Civil Code, in the Title on Damages, provides:

"Art. 2201. In contracts and quasi-contracts, the damages for which the obligor who acted in good faith is liable shall be those

that are the natural and probable consequences of the breach of the obligation, and which the parties have foreseen or could have reasonably foreseen at the time the obligation was constituted.

In case of fraud, bad faith, malice or wanton attitude, the obligor shall be responsible for all damages which may be reasonably attributed to the non-performance of the obligation."

"Art. 2220. Willful injury to property may be a legal ground for awarding moral damages if the court should find that, under the circumstances, such damages are justly due. The same rule applies to breaches of contract where the defendant acted fraudulently or in bad faith."[16]

"Art. 2232. In contracts and quasi-contracts, the court may award exemplary damages if the defendant acted in a wanton, fraudulent, reckless, oppressive, or malevolent manner."

"Art. 21. Any person who wilfully causes loss or injury to another in a manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage."[17]

(2) *Contractual breach committed in good faith/bad faith.* — The law distinguishes a contractual breach effected in good faith from one attended by bad faith. Where in breaching the contract, the defendant is not shown to have acted fraudulently or in bad faith (see Art. 2220.), liability for damages is limited to the natural and probable consequences of the breach of the obligation and which the parties had foreseen or could have reasonably foreseen; and in that case, such liability would not include liability for moral and exemplary damages. (China Airlines Limited vs. Court of Appeals, 211 SCRA 897 [1992].)

(a) In a case, L, a sister company of another company M, which was indebted to the defendant-creditor, filed a replevin suit for the recovery of certain office furnitures and equipment owned by M which the defendant sold at an auction sale for unpaid rentals of M. It was held that the act of L of filing a replevin suit without

[16]Bad faith in the context of Article 2220, includes *gross,* but not simple, negligence. But in a contract of *carriage,* moral damages are also allowed in case of death of a passenger attributable to the fault (which is presumed) of the common carrier. (see Arts. 1756, 1764; Far East Bank & Trust Co. vs. Court of Appeals, 241 SCRA 671 [1995]; see Lufthansa German Airlines vs. Court of Appeals, 243 SCRA 600 [1995].)

[17]Article 21 contemplates a conscious or deliberate act to cause harm approximating a degree of misconduct no less worse than fraud or bad faith. *(Ibid.)*

the intention of prosecuting the same but for the mere purpose of disappearing with the provisionally recovered property in order to evade lawfully contracted obligations constituted a wanton, fraudulent, reckless, oppressive and malevolent breach of contract which justified award of exemplary damages under Article 2232. (Stronghold Insurance Co., Inc. vs. Court of Appeals, 208 SCRA 336 [1992].)

(b) In another case, the unexplained misshipment of the subject goods destined for Manila but was inexplicably shipped to the United States, committed by the common carrier resulting in the unreasonable delay in the delivery of the same for more than two (2) months was held as constituting gross carelessness or negligence amounting to bad faith and wanton misconduct; hence, moral and exemplary damages were awarded to the aggrieved party. (Maersk Line vs. Court of Appeals, 223 SCRA 108 [1993].)

(3) *With respect to moral damages.* — They are not punitive in nature. Although incapable of pecuniary estimation, such damages must somehow be proportional to and in approximation of the suffering inflicted, the factual basis for which must be satisfactorily established by the aggrieved party. (Phil. National Bank vs. Court of Appeals, 395 SCRA 272 [2003].)

EXAMPLE:

S agreed to sell and deliver certain goods to B on a certain date for P300,000.00. Then, B agreed to sell the goods to be received from S to C for P325,000.00. This contract with C was known to S. On the date designated, S did not deliver the goods so that C bought the goods from another. The breach of the obligation by S, resulting in the loss of the amount of P25,000 as expected profit, so angered B that he suffered a heart attack for which he was hospitalized for five (5) days.

In this case, if S acted in good faith, the damage which B ought to receive should be the amount of P25,000, the profit which B failed to realize. (par. 1, Art. 2200.) But, if S acted in bad faith, he is also liable to pay for the hospitalization expenses incurred by B which clearly originated from the breach although they might not have been reasonably contemplated by the parties at the time they entered into the contract.

(4) *Code of Commerce provisions.* — The principle of limited liability in maritime law is enunciated in the following provisions of the Code of Commerce:

"Art. 587. The ship agent shall also be civilly liable for the indemnities in favor of third persons which may arise from the conduct of the captain in the care of goods which he loaded on the vessel; but he may exempt himself therefrom by abandoning the vessel with all the equipments and the freight it may have earned during the voyage."

"Art. 590. The co-owners of a vessel shall be civilly liable in the proportion of their interests in the common fund for the results of the acts of the captain referred to in Art. 587."

"Art. 837. The civil liability incurred by shipowners in the case prescribed in this section, shall be understood as limited to the value with all the appurtenances and the freightage served during the voyage."

Article 837 applies the principle of limited liability in cases of collision, hence, Articles 587 and 590 embody the universal principle of limited liability in all cases. "No vessel, no liability," expresses in a nutshell the limited liability rule. The liability of the owner or agent arising from the operation of the ship is confined to the vessel, equipment, and freight, or insurance, if any. (Monarch Insurance Co., Inc. vs. Court of Appeals, 333 SCRA 71 [2000].) Where the shipowner fails to overcome the presumption of negligence, the doctrine of limited liability cannot be applied. (Aboitiz Shipping Corp. vs. New India Assur. Co., Ltd., 531 SCRA 134 [2007].)

### Kinds of diligence required.

*Diligence* is "the attention and care required of a person in a given situation and is the opposite of negligence." (Sambijon vs. Suing, 503 SCRA 1 [2006].) Under Article 1173, the following kinds of diligence are required:

(1) that agreed upon by the parties, orally or in writing;

(2) in the absence of stipulation, that required by law in the particular case (like the extraordinary diligence[18] required of common carriers); and

[18]In view of the fiduciary nature of their relationship with their depositors, the degree of diligence required of bank is more than that of a reasonable man or a good faith of a family. (BPI vs. Lifetime Marketing Corp., 555 SCRA 372 [2008].)

(3) if both the contract and law are silent, then the diligence expected of a good father of a family (par. 2.) or ordinary diligence.

Whether or not the negligence of the obligor is excusable will depend on the degree of diligence required of him. Under No (3), for example, the obligor is not liable for damages where his negligence is one which ordinary diligence and prudence could not have guarded against.

**ART. 1174. Except in cases expressly specified by the law, or when it is otherwise declared by stipulation, or when the nature of the obligation requires the assumption of risk, no person shall be responsible for those events which could not be foreseen, or which, though foreseen, were inevitable. (1105a)**

### Meaning of fortuitous event.

A *fortuitous event* is any extraordinary event which cannot be foreseen, or which, though foreseen, is inevitable. In other words, it is an event which is either impossible to foresee or impossible to avoid.

The essence of a fortuitous event consists of being a happening independent of the will of the obligor and which happening, makes the normal fulfillment of the obligation impossible.

### Fortuitous event distinguished from *force majeure*.

(1) *Acts of man.* — Strictly speaking, fortuitous event is an event independent of the will of the obligor but not of other human wills, *e.g.*, war, fire, robbery, murder, insurrection, etc.

(2) *Acts of God.* — They are those events which are totally independent of the will of every human being, *e.g.*, earthquake, flood, rain, shipwreck, lightning, eruption of volcano, etc. They are also called *force majeure.* The term generally applies to a natural accident.

In our law, fortuitous events and *force majeure* are identical in so far as they exempt an obligor from liability. Both are independent of the will of the obligor. (Republic vs. Luzon Stevedoring Corp., 21 SCRA 279 [1967]; University of Santo Tomas vs. Descals, 38 Phil. 287 [1918].)

### Kinds of fortuitous events.

In speaking of the contract of lease, our Civil Code distinguishes between two kinds of fortuitous events, namely:

(1) *Ordinary fortuitous events* or those events which are common and which the contracting parties could reasonably foresee (*e.g.*, rain); and

(2) *Extraordinary fortuitous events* or those events which are uncommon and which the contracting parties could not have reasonably foreseen (*e.g.*, earthquake, fire, war,[19] pestilence, unusual flood). (see Art. 1680, par. 2.)

**Requisites of a fortuitous event.**

Whether an act of man or an act of God, to constitute a fortuitous event, it is essential that:

(1) The event must be independent of the human will or at least of the obligor's will;

(2) The event could not be foreseen (unforeseeable), or if it could be foreseen, must have been impossible to avoid (unavoidable);

(3) The event must be of such a character as to render it impossible for the obligor to comply with his obligation in a normal manner; and

(4) The obligor must be free from any participation in, or the aggravation of the injury to the obligee. (see Lasam vs. Smith, 45 Phil. 657 [1923]; see General Enterprises, Inc. vs. Lianga Bay Logging Co., Inc., 11 SCRA 733 [1964]; Tugade vs. Court of Appeals, 85 SCRA 226 [1978]; Juntilla vs. Fontaner, 136 SCRA 624 [1985].)

The absence of any of the above requisites (all of which must be proved) would prevent the obligor from being exempt from liability.

**Concurrent or previous negligence of obligor.**

There must be no concurrent or previous negligence or imprudence on the part of the obligor by which the loss or injury may have been occasioned.

When the effect is found to be in part the result of the participation of man, whether due to his active intervention or neglect or failure to act, the whole occurrence is then humanized and removed from the

[19]War, or its effects, or other factors which could not have been foreseen or avoided by a party, such as uncertain conditions of peace and order then prevailing which the court may take judicial notice of, are deemed sufficient causes that could justify the non-fulfillment of a contract and exempt the party from responsibility. (Phil. National Bank vs. Court of Appeals, 94 SCRA 357 [1979].)

rules applicable to the acts of God. (National Power Corporation vs. Court of Appeals, 211 SCRA 162 [1992], 222 SCRA 415 [1993]; see Metal Forming Corp. vs. Office of the President, 246 SCRA 731 [1995]; Schmitz Transport & Brokerage Corp. vs. Transport Ventures, Inc., 456 SCRA 557 [2005].) If the loss or injury could have been avoided by human precaution, the defense of fortuitous event cannot be successfully invoked. In other words, in order to be exempt from liability arising from a fortuitous event, there should have been no human participation amounting to a negligent act. (Southwestern College, Inc. vs. Court of Appeals, 292 SCRA 422 [1998].) For example, robbery or carnapping *per se* is not a fortuitous event. Merely presenting the police report on the crime is not sufficient to establish it happened nor prove that the obligor was not at fault. The burden of proving that the loss was due to a fortuitous event rests on him who invokes it. (Sicam vs. Jorge, 529 SCRA 443 [2007].)

ILLUSTRATIVE CASES:

1. *Where the car was driven by an unlicensed chauffeur, the breach of the contract of carriage cannot be said to be due to a fortuitous event.*

*Facts:* X, engaged in the business of carrying passengers for hire, undertook to convey B and C from one point to another in an automobile. The automobile was operated by a licensed chauffeur who later allowed his assistant who had no license but had some experience in driving, to drive the car.

Defects developed in the steering gear and after zigzagging for a distance, the car left the road and went down a deep embankment. B and C suffered physical injuries.

*Issue:* Is X liable in damages?

*Held:* Yes. X's liability is contractual. (see Lakes vs. Atlantic Gulf & Pacific Co., 7 Phil. 359 [1907]; Cangco vs. Manila Railroad Co., 38 Phil. 788 [1918]; Manila Railroad Co. vs. Cia Transatlantica and Atlantic Gulf & Pacific Co., 38 Phil. 875 [1918]; De Guia vs. Manila Electric Railroad & Light Co., 40 Phil. 706 [1920].) By entering into the contract of carriage, X bound himself to carry B and C safely and securely to their destination and having failed to do, he is liable in damages unless he shows that the failure to fulfill his obligation was due to causes mentioned in Article 1605. (now Art. 1174.) Upon the facts stated, the breach of the contract was not due to fortuitous events. *(Lasam vs. Smith, 45 Phil. 657 [1923].)*

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2. *Trust funds deposited by trustee in a bank in his personal account are lost due to a fortuitous event.*

*Facts:* T received trust funds which he deposited in a bank in his personal account. Said trust funds were part of the funds which were removed and confiscated by the military authorities of the United States.

*Issue:* Is T liable to repay the money?

*Held:* No. If the money had been forcibly taken from his pocket or from his house by the military forces of one of the combatants during a state of war, it is clear that under Article 1163 *(supra.)*, he would have been exempted from responsibility. The fact that he placed the trust fund in the bank in his personal account did not add to his responsibility. Such deposit did not make him a debtor who must respond to all hazards. *(Roman Catholic Bishop of Jaro vs. De la Pena, 26 Phil. 144 [1913].)*

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3. *Specific thing to be delivered is lost due to a fortuitous event.*

*Facts:* In an action for collection of a sum of money, X obtained a preliminary attachment on three (3) carabaos of B. To secure the release of the carabaos, C and D executed a bond guaranteeing the delivery by B or in the event that he should fail to do so, the payment of their value in case judgment should be against B.

The carabaos died of a prevailing disease in the locality. Final judgment was rendered against B.

*Issue:* Are C and D liable for the value of the carabaos?

*Held:* No. The death of the carabaos being fortuitous, it results upon the one hand, that the obligation contracted by C and D to return or deliver up the said carabaos was extinguished as a matter of fact and of law (see Art. 1262.), and on the other, that they were exempted from the other subsidiary obligation contracted by them to pay the value of said carabaos in default of the carabaos themselves because, in accordance with Article 1174, unless the case falls under any of the exceptions expressly mentioned, no one should be held to account for fortuitous events. *(Creme Sy Panco vs. Gonzaga, Phil. 646 [1908].)*

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4. *Petitioner spouses sued respondent for breach of contract with damages for failure of the latter to record on video petitioners' wedding celebration due to gross negligence.*

*Facts:* Petitioner spouses EH and RH contracted the services of PVE, subsidiary of SD, Inc., for the betamax coverage of their forthcoming

wedding celebration scheduled in the morning of October 11, 1986. The suit for breach of contract with damages stemmed from the failure of PVE to record on video petitioners' wedding celebration allegedly due to the gross negligence of its crew as well as the lack of supervision on the part of the general manager of PVE.

PVE disclaimed any liability for the damaged videotape by invoking *force majeure* or fortuitous event and asserted that a defective transistor caused the breakdown in its videotape recorder.

The defect was discovered for the first time after the wedding reception at the Manila Hotel.

*Issue:* Should PVE be exempt from liability on ground of fortuitous event?

*Held:* No. "In order that a fortuitous event may exempt PVE or respondent Solid Distributors, Inc., from liability, it is necessary that it be free from negligence. The alleged malfunctioning of the videotape recorder occurred at the beginning of the video coverage at the residence of the bride. There appeared to be no valid reason why the alleged defect in the video tape recorder had gone undetected. There was more than sufficient time for the PVE crew to check the video tape recorder for the reason that they arrived at the bride's residence at 6:30 o'clock in the morning while they departed for the wedding ceremonies at the Malate Church at 9:00 o'clock in the morning. x x x

We take judicial notice of the short distance between the office of PVE or respondent Solid Distributors, Inc. at 1000 J. Bocobo corner Kalaw Streets, Ermita, Manila, on one hand, and the locations of the required video tape coverage at the residence of the bride at M.H. Del Pilar Street, Ermita, Manila, the Malate Church and the Manila Hotel. The failure to record on videotape the wedding celebration of the petitioners constitutes malicious breach of contract as well as gross negligence on the part of respondent Solid Distributors, Inc.

PVE or SD, Inc. cannot seek refuge under Article 2180 of the New Civil Code by claiming that it exercised due care in the selection and supervision of its employees and that its employees are experienced in their respective trade. That defense, as provided in the last paragraph of Article 2180 of the New Civil Code, may be availed of only where the liability arises from *culpa aquilana* and not from *culpa contractual*." *(Herbosa vs. Court of Appeals, 374 SCRA 578 [2002].)*

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5. *Mere pecuniary inability or poverty as an excuse for nonfulfillment of an obligation.*[20]

*Fact:* To secure a loan, R mortgaged a parcel of land to Development Bank of the Phil. (formerly RFC). The plantation for which the loan was obtained was attacked by mosaic diseases by reason of which R was unable to pay the yearly amortizations.

The mortgage was foreclosed. The court rendered a deficiency judgment against R.

*Issue:* Is R entitled to a reduction, if not exemption, from the loan because of his inability to realize any income from the abaca he planted?

*Held:* No. His predicament may evoke sympathy, but it does not justify a disregard of the terms of the contract he entered into. His obligation thereunder is neither conditional nor aleatory; its terms are clear and subject to no exception. (*Development Bank of the Phil. vs. Mirang, 66 SCRA 141 [1975]; see also* Repide vs. Alzeiluz, 39 Phil. 194 [1918].)

### Rules as to liability in case of fortuitous event.

A person is not, as a rule, responsible for loss or damage resulting from fortuitous events. In other words, his obligation is extinguished. The exceptions are enumerated below.

(1) *When expressly specified by law.*[21] — In exceptions (a), (b), and

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[20]The suspension of the operations of a bank by the Central Bank cannot excuse non-compliance with its obligation to remit the time deposits of depositors who have nothing to do with the Central Bank's actuations or the events leading to the bank's distressed financial state. (Overseas Bank of Manila, Inc. vs. Court of Appeals, 172 SCRA 521 [1989].)

[21]Other cases are:

Art. 552. A possessor in good faith shall not be liable for the deterioration or loss of the thing possessed, except in cases in which it is proved that he has acted with fraudulent intent or negligence, after the judicial summons.

A possessor in bad faith shall be liable for deterioration or loss in every case, even if caused by a fortuitous event. (457a)

Art. 1740. If the common carrier negligently incurs in delay in transporting the goods, a natural disaster shall not free such carrier from responsibility.

Art. 1942. The bailee is liable for the loss of the thing, even if it should be through a fortuitous event:

(1) If he devotes the thing to any purpose different from that for which it has been loaned;

(2) If he keeps it longer than the period stipulated, or after the accomplishment of the use for which the commodatum has been constituted;

(3) If the thing loaned has been delivered with appraisal of its value, unless there is a stipulation exempting the bailee from responsibility in case of a fortuitous event;

(c) below, the special strictness of the law is justified.

(a) The debtor is guilty of fraud, negligence, or delay, or contravention of the tenor of the obligation. (Arts. 1170, 1165, par. 3.)

(b) The debtor has promised to deliver the same (specific) thing to two or more persons who do not have the same interest for it would be impossible for the debtor to comply with his obligation to two or more creditors even without any fortuitous event taking place. *(Ibid.)*

(c) The debt of a thing certain and determinate proceeds from a criminal offense, unless the thing having been offered by the debtor to the person who should receive it, the latter refused without justification to accept it. (Art. 1268.)

(d) The thing to be delivered is generic (Art. 1263.) for the debtor can still comply with his obligation by delivering another thing of the same kind in accordance with the principle that "genus never perishes" *(genus nunquam perit).*

(2) *When declared by stipulation.* — The basis for this exception rests upon the freedom of contract. (See Art. 1306.) Such a stipulation is usually intended to better protect the interest of the creditor and procure greater diligence on the part of the debtor in the fulfillment of

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(4) If he lends or leases the thing to a third person, who is not a member of his household;

(5) If, being able to save either the thing borrowed or his own thing, he chose to save the latter. (1744a and 1745)

Art. 1979. The depositary is liable for the loss of the thing through a fortuitous event:

(1) If it is so stipulated;

(2) If he uses the thing without the depositor's permission;

(3) If he delays its return;

(4) If he allows others to use it, even though he himself may have been authorized to use the same. (n)

Art. 2147. The officious manager shall be liable for any fortuitous event:

(1) If he undertakes risky operations which the owner was not accustomed to embark upon;

(2) If he has preferred his own interest to that of the owner;

(3) If he fails to return the property or business after demand by the owner;

(4) If he assumed the management in bad faith. (1891a)

Art. 2159. Whoever in bad faith accepts an undue payment, shall pay legal interest if a sum of money is involved, or shall be liable for fruits received or which should have been received if the thing produces fruits.

He shall furthermore be answerable for any loss or impairment of the thing from any cause, and for damages to the person who delivered the thing, until it is recovered. (1896a)

his obligation. But the intention to make the debtor liable even in case of a fortuitous event should be clearly expressed.

ILLUSTRATIVE CASES:

1. *Stipulation in a firearm bond makes licensee responsible for fortuitous events.*

*Facts:* X was issued a license for the possession of four firearms for which he gave a bond. He failed to comply with the terms of the bond, claiming that the failure was due to *force majeure, i.e.,* that his house was attacked by a band of robbers who carried away three of them.

*Issue:* Is X relieved from responsibility upon the bond which he had given for their return?

*Held:* No. It may be said that Article 1174 may be a harsh rule when applied to a case like the present, but it must be remembered that no private person is bound to keep arms. Whether he does or not is entirely optional with himself but if, for his own convenience or pleasure, he desires to possess arms he must do upon such terms as the government sees fit to impose for the right to keep and bear arms is not secured to him by law. The government can impose upon him such terms as it pleases. *(Insular Government vs. Armechazurra, 10 Phil. 637 [1908].)*

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2. *Responsibility for fortuitous events is not clearly stipulated.*

*Facts:* In the contract, it is declared the duty of E, lessee, to maintain the improvements of the hacienda in good condition and to deliver them in the same state to R, lessor, upon the termination of the lease.

*Issue:* Is E responsible for loss resulting from fortuitous events?

*Held:* No. The above is merely a statement of the obligation imposed by law, generally upon all lessees. (see Arts. 1657[2], 1665.) It is true that under Article 1174 a party to a contract may make himself responsible for loss occurring without his fault. But the provision imposing this obligation should be clearly expressed. Where the parties to a contract desire to create an unusual obligation, the expression of an intention to that effect should be clear. *(Lizares vs. Hernaez and Alunan, 40 Phil. 981 [1920].)*

(3) *When the nature of the obligation requires the assumption of risk.* — Here, risk of loss or damage is an essential element in the obligation.

EXAMPLE:

D insured his house against fire for P500,000.00 with R, an insurance company. Later, the house was destroyed by accidental fire.

Although the cause of the loss is a fortuitous event, D may recover the amount of the policy. In a contract of insurance, the insurer (R), in consideration of the premium paid by the insured (D), undertakes to indemnify the latter for the loss of the thing insured by reason of the peril insured against even if the cause of the loss is a fortuitous event.

**Effect where risk not one impossible to foresee.**

(1) Where the risk is quite evident such that the possibility of danger is not only foreseeable, but actually foreseen, then it could be said that the nature of the obligation is such that a party could rightfully be deemed to have assumed it. Under Article 1174, the event must be one impossible to foresee or to avoid in order that a party may not be said to have assumed the risk resulting from the nature of the obligation itself. (Dioquino vs. Laureano, 33 SCRA 65 [1970].)

(2) Mere difficulty to foresee the happening of an event is different from impossibility to foresee or anticipate the same. (Republic vs. Luzon Stevedoring Corp., 21 SCRA 279 [1967].)

(a) The 1997 financial crisis that ensued in Asia did not constitute a valid justification to renege on obligations; it is not among the fortuitous events contemplated under Article 1174. Mondragon Leisure and Resorts Corporation vs. Court of Appeals, 460 SCRA 279 [2005]; Asian Construction & Dev. Corp. vs. Phil. Commercial International Bank, 488 SCRA 192 [2006].)

(b) A real estate enterprise engaged in the pre-selling of condominium units is concededly a master in projections on commodities and currency movements and business risks. The fluctuating movements of the Philippine peso in the foreign exchange market is an everyday occurrence, and fluctuations in currency exchange rates happen everyday; thus, not an instance of *caso fortuito*. (Fil-Estate Properties, Inc. vs. Go., 530 SCRA 624 [2007].)

ILLUSTRATIVE CASES:

1. *Happening of event was foreseen.*

*Facts:* A barge owned by LSC was being towed down the Pasig river by two of its tugboats, when it rammed against one of the wooden piles of the Nagtahan bailey bridge, smashing the posts and causing the bridge to list. The river, at that time, was swollen and the current swift, on account of the heavy downpour for two days before.

Sued by R (Republic of the Philippines) for damages caused by its employees, LSC disclaimed responsibility on the ground, among others, that the damages caused to the bridge were caused by *force majeure* or fortuitous event. LSC strongly stresses the precautions taken by it on the day in question: that it assigned two of its most powerful tugboats to tow the barge down the river; that it assigned to the task the more competent and experienced among its *patrons;* had the towliness, engines, and equipment double-checked and inspected; that it instructed its *patrons* to take extra-precautions; and concludes it had done all it was called to do.

*Issue:* Whether or not the collision of LSC's barge with the supports or piers of the Nagtahan bridge was, in law, caused by fortuitous event or *force majeure*?

*Held:* (1) *Precautions adopted by LSC's showed risk anticipated.* — These very precautions completely destroy LSC's defense. Under Article 1174, it is not enough that the event should not have been foreseen or anticipated, as is commonly believed, but it must be one impossible to foresee or to avoid. The mere difficulty to foresee the happening is not impossibility to foresee the same. The very measures adopted by LSC prove that the possibility of danger was not unforeseeable, but actually foreseen, and was not *caso fortuito.*

(2) *LSC assumed risk.* — Otherwise stated, LSC, knowing and appreciating the perils posed by the swollen stream and its swift current, voluntarily entered into a situation involving obvious danger; it, therefore, assumed the risk, and cannot shed responsibility merely because the precautions it adopted turned out to be insufficient.

(3) *LSC presumed negligent.* — Furthermore, considering that the Nagtahan bridge was an immovable and stationery object and provided with adequate openings for the passage of water craft, the unusual event that the barge, exclusively controlled by LSC, rammed the bridge raises a presumption of negligence on the part of LSC or its employees manning the barge or the tugs that towed it. For in the ordinary course of events, such thing does not happen if proper care is used. *(Republic vs. Luzon Stevedoring Corp., supra.)*

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2. *Happening of event was clearly unforeseen.*

*Facts:* B borrowed the car of L. While about to reach his destination, the car driven by L's driver and with B as the sole passenger, was accidentally stoned by some "mischievous boys" playing along the road and its windshield was broken.

*Issue:* Did B assume the risk of the car being stoned?

*Held:* No. What happened was clearly unforeseen. It was a fortuitous event which must be borne by the owner (L) of the car. The very wording of Article 1174 dispels any doubt that what is therein contemplated is the resulting liability even if caused by a fortuitous event where the party charged may be considered as having assumed the risk incident in the nature of the obligation to be performed.

It would be an affront, not only to logic but to the realities of the situation, if B could be held as bound to assume the risk of this nature. In the case of *Republic vs. Luzon Stevedoring Corporation, supra,* the risk was quite evident and the nature of the obligation such that a party could rightfully be deemed as having assumed it. It is not so in the case at bar. *(Dioquino vs. Laureano, 33 SCRA 65 [1970].)*

**Impossibility of performance must result from occurrence of fortuitous event.**

It should be pointed out that for the purpose of releasing the debtor from his obligation, the occurrence of the fortuitous event does not suffice. The impossibility of fulfilling the obligation must be the direct consequence of the event. If notwithstanding its occurrence, the obligation can be fulfilled, it will subsist even if only in part.

In order to see whether or not the fortuitous event produces the impossibility of fulfilling the obligation, the nature of the obligation must be considered, and according to whether it be specific or general, etc., it will or will not be extinguished. (8 Manresa 91; Tan Chiong Sian vs. Inchausti & Co., 22 Phil. 152 [1912].)

**Effect of obligor's negligence upon his liability.**

(1) *Negligence contributed to the loss or damage*. — In order that fortuitous event may release a debtor from his obligation, it is necessary that he be free from previous negligence or misconduct by which the loss or damage may have been occasioned. When the negligence of a person concurs with a fortuitous event in producing a loss, he is not exempted from liability by showing that the immediate cause of the damage was the fortuitous event. (8 Manresa 94; see FGU Insurance Corporation vs. Court of Appeals, 454 SCRA 337 [2005].)

(a) Otherwise stated, in order to completely exonerate the debtor by reason of a fortuitous event, such debtor must, in addition to the *casus* itself, be free of any concurrent or contributory fault or

negligence. This is apparent from Article 1170. (Austria vs. Court of Appeals, 39 SCRA 527 [1971].) Thus, one who has placed property of another, entrusted to his care, in an unseaworthy vessel, upon dangerous waters, cannot absolve himself by crying, "an act of God" when every effect which a typhoon produced upon that property could have been avoided by the exercise of common care and prudence. (Tan Chiong Sian vs. Inchausti & Co., *supra.*)

(b) Where the loss is caused by an "act of God," "if the negligence of the [defendant] mingles with it as an active and cooperative cause, he is still responsible." *(Ibid.)* Stated differently, "one who negligently creates a dangerous condition cannot escape liability for the natural and probable consequences thereof, although the act of a third person, or an act of God for which he is not responsible, intervenes to precipitate the loss. (Nakpil & Sons vs. Court of Appeals, 144 SCRA 596 [1986].)

(2) *Negligence not contributory to the loss or damage.* — But where both fortuitous event and lack of due diligence are present under conditions that the loss would have happened with or without the negligence of the obligor — hence, the consequences are all a derivation of the fortuitous event — it cannot be said that responsibility arises therefrom. (*Ibid*.; see 8 Manresa 94-95.) In such a case, however, the courts are not bound to discharge the obligor from all liability. Under the law (Art. 2215[4].), where "the loss would have resulted in any event," they "may equitably mitigate the damages" which in view of the circumstances the obligor should pay.

ILLUSTRATIVE CASE:

*Quantum of proof required to establish that a fortuitous event did take place.*

*Facts:* A (agent) received from P (principal) a pendant with diamonds to be sold on commission basis, which A later on failed to return because of a robbery committed upon her. P brought action for the recovery of the pendant.

*Issue:* To avail of the exemption granted in Article 1174, is it necessary that there be a prior finding of guilt of the person or persons responsible for the robbery?

*Held:* No. It would only be sufficient to establish that the unforeseeable event, the robbery in this case, did take place without any concurrent fault on the debtor's (A's) part, and this can be done by preponderant

evidence. To require in the present action for recovery the prior conviction of the culprits in the criminal case, in order to establish robbery as a fact, would be to demand proof beyond reasonable doubt to prove a fact in a civil case. *(Austria vs. Court of Appeals, supra.)*

**ART. 1175. Usurious transactions shall be governed by special laws. (n)**

### Meaning of simple loan or mutuum.

*Simple loan* or *mutuum* is a contract whereby one of the parties delivers to another money or other consumable thing, upon the condition that the same amount of the same kind and quality shall be paid. It may be gratuitous or with a stipulation to pay interest. (Art. 1933.)

### Meaning of usury.

*Usury* is contracting for or receiving interest in excess of the amount allowed by law for the loan or use of money, goods, chattels, or credits. (Tolentino vs. Gonzales, 50 Phil. 558 [1927].)

### Kinds of interest.

They are:

(1) *Simple interest.* — when the rate of interest is stipulated by the parties (Art. 2209.);

(2) *Compound interest.* — when the interest earned is upon interest due (Arts. 2212, 1959.);

(3) *Legal interest.* — when the rate of interest intended by the parties is presumed by law, as when the loan mentions interest but does not specify the rate thereof. (Art. 2209.) The same rate is allowed in judgments where there is no express contract between the parties in anticipation of the same. Its use is not justified where there is a stipulated rate of interest in the loan contract;

(4) *Lawful interest.* — when the rate of interest is within the maximum allowed by (usury) law (Secs. 2, 3, Usury Law, Act No. 2655, as amended.); and

(5) *Unlawful interest.* — when the rate of interest is beyond the maximum fixed by law.

**Interest rules.**

Under the Usury Law, they are:

(1) *Legal rate. — 12% per annum.* (see Sec. 1, *Ibid.*) The legal rate is 12% (from default until fully paid) if the transaction is a loan or forbearance of money, goods, or credits or the judgment involves a loan or forbearance of money, goods or credits, as prescribed in Central Bank Circular No. 416 *(infra.);* otherwise (*e.g.*, indemnity for damages occasioned by an injury to person or loss of property), it is only 6% as provided in Article 2209 of the Civil Code. *(infra.)*

(2) *Maximum rate:*

(a) 12% *per annum* — if the loan is secured in whole or in part by a mortgage upon real estate with a Torrens Title or by any agreement conveying such real estate (also registered) or an interest therein. For purposes of the ceiling, loans secured by government securities such as treasury bills, CB certificates of indebtedness, etc., qualify as secured loans; and

(b) 14% *per annum* — if the loan is not secured as provided above; or

(c) The rate prescribed by the Monetary Board of the Central Bank. (Secs. 1, 1-a, 2, 3, [Usury Law].)

Under Section 2 (secured loan) of the Usury Law, the taking or receiving (not mere agreeing) of usurious interest is the act penalized. Under Section 3 (unsecured loan), the mere demanding or agreeing to charge excessive interest is also punishable. In either case, it is only the creditor who is criminally liable. To conceal usury, various devices (*e.g.*, sale with right of repurchase under Art. 1602 of the Civil Code) have been resorted to whereby the true nature of the transaction is concealed from what may be viewed from the written agreement. (see Art. 1346.)

**Requisites for recovery of monetary interest.**

Interest fixed by the parties to a contract for the ease or forbearance of money is referred to as *monetary* interest. It is called *compensatory interest* if it is imposed by law or by courts as penalty or indemnity for damages. (Siga-an vs. Villanueva, 576 SCRA 696 [2009].)

In order that monetary interest may be recovered, the following requisites must be present:

(1) The payment of interest must be expressly stipulated (Art. 1956.);

(2) The agreement must be in writing; and

(3) The interest must be lawful. (Art. 1957.)

A stipulation for the payment of usurious interest is void, that is, as if there is no stipulation as to interest. (see comments under Art. 1413.)

*Note:* By virtue of Central Bank Circular No. 905 (Dec. 10, 1982, effective Jan. 1, 1983.) issued by the Monetary Board under the authority granted to it by the Usury Law (Secs. 1-a, 4-9, and 4-b thereof.), the rate of interest and other charges on a loan or forbearance of money, goods, or credit, regardless of maturity and whether secured and unsecured, that may be charged or collected shall not be subject to any ceiling prescribed under the Usury Law. *Usury is now legally non-existent*. Interest can be charged as lender and borrower may agree upon. (Liam Law vs. Olympic Sawmill Co., 129 SCRA 439 [1984].) According to the Supreme Court, the circular did not repeal or in any way amend the Usury Law but simply suspended the latter's effectivity. Only a law can repeal or amend another law. (Security Bank & Trust Co. vs. RTC of Makati, 263 SCRA 483 [1996]; Banco Filipino Savings and Mortgage Bank vs. Ybañez, 445 SCRA 482 [2004].)

While the Usury Law ceiling on interest rates was lifted by C.B. Circular No. 905, nothing in said circular grants lenders *carte blanche* authority to raise interest rates to levels which will either enslave their borrowers or lead to a hemorrhaging of their assets. (Almeda vs. Court of Appeals, 256 SCRA 292 [1996]; Solangon vs. Salazar, 360 SCRA 379 [2001]; see Note to Art. 1229; Toring vs. Ganzon-Olan, 568 SCRA 376 [2008].)

**Liability for legal interest.**

(1) *Loan or forbearance of money.* — When the obligation consists in the payment of money (*i.e.,* loan or forbearance of money, goods or credits), the interest due should be that which may have been stipulated in writing. Legal interest in the nature of (actual and compensatory) damages for non-compliance with an obligation to pay a sum of money is recoverable even if not expressly stipulated in writing. (Integrated Realty Corp. vs. Philippine National Bank, 174 SCRA 295 [1989]; see Art. 2209.)

(a) The debtor in delay is liable to pay interest which is 6% *per annum,* now 12%, by virtue of Central Bank Circular No. 416 (July 29, 1974) and No. 905 (Dec. 10, 1982), as indemnity for damages even in the absence of stipulation for the payment of interest computed from default, *i.e.,* from judicial or extrajudicial demand. (Art. 1169.) The claim for legal interest and increase in the indemnity may be entertained by the appellate court in spite of the failure of the claimant to appeal the judgment where the appeal of the defendant was obviously dilatory and oppressive of the rights of the claimant. (De Lima vs. Laguna Tayabas Co., 160 SCRA 70 [1988].)

(b) Furthermore, interest *due* shall earn legal interest from the time it is judicially demanded although the obligation may be silent upon this point. (Art. 2212; Cortes vs. Venturanza, 79 SCRA 709 [1977].) Where no interest had been stipulated by the parties, the debtor is not liable to pay compound interest even after judicial demand for in such case, there can be no accrued (conventional) interest which can further earn interest upon judicial demand. (Phil. American Accident Insurance Co., Inc. vs. Flores, 97 SCRA 811 [1980]; David vs. Court of Appeals, 316 SCRA 710 [1999].)

(c) A debtor cannot be considered delinquent and liable to pay interest where he offered checks backed by sufficient deposit or is ready to pay cash if the creditor chose that means of payment. (G. Araneta, Inc. vs. De Paterno, 91 Phil. 786 [1952]; Bresterbos vs. Court of Appeals, 411 SCRA 396 [2003].)

(2) *Other than loan or forbearance of money.* — The rate of 12% interest referred to in C.B. Circular No. 416 applies only to loan or forbearance of money, goods or credit, or to cases where money is transferred from one person to another and the obligation to return the same or a portion thereof is adjudged. (Phil. National Bank vs. Court of Appeals, 263 SCRA 766 [1996].) When an obligation, not constituting a loan or forbearance of money (*e.g.,* obligation arises from a contract of purchase and sale) is breached, an interest on the amount of damages awarded may be imposed *at the discretion of the court* (see Art. 2210.), at the rate of 6% *per annum* as provided in Article 2209 of the Civil Code. (see Reformina vs. Tomol, Jr., 139 SCRA 260 [1985]; Sunga-Chan vs. Court of Appeals, 555 SCRA 275 [2008].)

(3) *Final and executory judgment awarding a sum of money.* — When the judgment of the court awarding a sum of money becomes final and

executory, the rate of legal interest, where the case falls under Nos. (1) or (2) above, shall be 12% *per annum* from such finality until its satisfaction, this interim period being deemed to be by then an equivalent to a forbearance of credit. The actual base for the computation of this 12% interest is the amount due upon the finality of the judgment. (Eastern Shipping Lines, Inc. vs. Court of Appeals, 234 SCRA 78 [1994]; De Lima vs. Laguna Bus Co., 160 SCRA 70 [1988]; Korean Airlines Co., Ltd. vs. Court of Appeals, 234 SCRA 717 [1994]; Montilla vs. Augustinian Corp., 25 Phil. 447 [1913]; Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999]; Eastern Assurance and Surety Corporation vs. Court of Appeals, 322 SCRA 73 [2000]; Bangko Sentral ng Pilipinas vs. Santamaria, 395 SCRA 84 [2003]; Almeda vs. Cariño, 395 SCRA 144 [2003]; Vicente vs. Planters Development Bank, 396 SCRA 282 [2003]; Heirs of O. Reyes vs. Mijares, 410 SCRA 97 [2003]; Cuaton vs. Salud, 421 SCRA 278 [2004]; Cosing vs. Court of Appeals, 425 SCRA 192 [2004]; Garamont Steamship Agencies, Inc. vs. Sprint Transport Services, Inc., 592 SCRA 622 [2009].)

(4) *Summary*. — The above rulings may be summarized as follows:

(a) *For loan or forbearance of money,* the rate of interest due is that stipulated; otherwise, 12% *per annum* computed from judicial or extrajudicial demand until fully paid. In addition, interest due shall earn legal interest (compound interest) from the time it is *judicially* demanded.

(b) *For other than loan or forbearance of money,* the interest shall be 6% as indemnity at the discretion of the court. When the amount of the obligation is reasonably established, the interest shall run from judicial or extra-judicial demand; otherwise, from the time the amount is finally adjudged.

(c) Where a *judgment awarding a sum of money* under (a) or (b) above, has become final and executory, the legal rate of interest shall be 12% from such finality, based on the adjudged principal and unpaid interest, until full satisfaction.

**ART. 1176. The receipt of the principal by the creditor, without reservation with respect to the interest, shall give rise to the presumption that said interest has been paid.**

**The receipt of a later installment of a debt without reservation as to prior installments, shall likewise raise the presumption that such installments have been paid. (1110a)**

### Meaning of presumption.

By *presumption* is meant the inference of a fact not actually known arising from its usual connection with another which is known or proved.

EXAMPLE:

D borrowed P1,000.00 from C. Later, D shows a receipt signed by C. The fact not actually known is the payment by D. The fact known is the possession by D of a receipt signed by C.

The presumption is that the obligation has been paid unless proved otherwise by C as, for example, that D forced C to sign the receipt.

### Two kinds of presumption.

They are:

(1) *Conclusive presumption.* — one which cannot be contradicted like the presumption that everyone is conclusively presumed to know the law (see Art. 3.); and

(2) *Disputable (or rebuttable) presumption.* — one which can be contradicted or rebutted by presenting proof to the contrary like the presumption established in Article 1176. (see Sec. 69[i], Rule 123, Rules of Court.)

EXAMPLES:

(1) B owes C the amount of P10,000.00 with interest at 14% a year. C issued a receipt for the principal. The interest was not referred to in the payment whether or not it has been paid.

It is presumed that the interest has been previously paid by B because normally the payment of interest precedes that of the principal. (Art. 1253.) This, however, is only a disputable presumption and may be overcome by sufficient evidence that such interest had not really been paid. (Art. 1176, par. 1; see Hill vs. Veloso, 31 Phil. 160 [1915].)

(2) E is a lessee in the apartment of R, paying P5,000.00 rental a month, E failed to pay the rent for the months of February and March. In April, E paid P5,000.00 and R issued a receipt that the payment is for the month of April.

The presumption is that the rents for the months of February and March had already been paid. This is also in accordance with the usual business practice whereby prior installments are first liquidated before payments are applied to the later installments. Again, this presumption

is merely disputable. (Art. 1176, par. 2; see Rubert and Guamis vs. Smith, 11 Phil. 138 [1908]; Perez vs. Garcia Bosque, 7 Phil. 162 [1906]; Manila Trading & Supply Co. vs. Medina, 2 SCRA 549 [1961].)

**When presumptions in Article 1176 do not apply.**

(1) *With reservation as to interest.* — The presumptions established in Article 1176 do not arise where there is a reservation as to interest or prior installments, as the case may be. The reservation may be made in writing or verbally.

(2) *Receipt for a part of principal.* — The first paragraph of Article 1176 only applies to the receipt of the last installment of the entire capital, not to a mere fraction thereof. This is logical. A receipt for a part of the principal, without mentioning the interest, merely implies that the creditor waives his right to apply the payment first to the interest and then to the principal, as permitted by Article 1253. *(infra.)* Only when the principal is fully receipted for, may failure to reserve the claim for interest give rise to the presumption that said interest has been paid. (see Jocson vs. Capital Subdivision, Inc., [CA] No. 7635-R, Jan. 6, 1953.)

(3) *Receipt without indication of particular installment paid.* — It has been held that the presumption in paragraph 2, Article 1176 is not applicable if the receipt does not recite that it was issued for a particular installment due as when the receipt is only dated. Thus, in the preceding example (No. 2), the fact alone that the receipt issued by R is dated April 5, does not justify the inference that the rents for February and March had been paid. (see Manila Trading & Co. vs. Medina, *supra.*)

(4) *Payment of taxes.* — Article 1176 does not apply to the payment of taxes. Taxes payable by the year are not installments of the same obligation.

(5) *Non-payment proven.* — Of course, Article 1176 is not applicable where the non-payment of the prior obligations has been proven. Between a proven fact and a presumption *pro tanto,* the former stands, and the latter falls. (Ledesma vs. Realubin, 8 SCRA 608 [1963].)

**ART. 1177. The creditors, after having pursued the property in possession of the debtor to satisfy their claims, may exercise**

**all the rights and bring all the actions of the latter for the same purpose, save those which are inherent in his person; they may also impugn the acts which the debtor may have done to defraud them. (1111)**

## Remedies available to creditors for the satisfaction of their claims.

In case the debtor does not comply with his obligation, the creditor may avail himself of the following remedies to satisfy his claim:

(1) exact fulfillment (specific performance) with the right to damages;

(2) pursue the leviable (not exempt from attachment under the law) property of the debtor;

(3) "after having pursued the property in possession of the debtor," exercise all the rights (like the right to redeem) and bring all the actions of the debtor[22] (like the right to collect from the debtor of his debtor) except those inherent in or personal to the person of the latter (such as the right to vote, to hold office, to receive legal support, to revoke a donation on the ground of ingratitude, etc.); and

(4) ask the court to rescind or impugn acts or contracts which the debtor may have done to defraud him when he cannot in any other manner recover his claim.[23] (see Arts. 1380-1389.)

The debtor is liable with all his property, present and future, for the fulfillment of his obligations, subject to the exemptions provided by law.[24] (see Art. 2236.)

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[22]This remedy, which is sometimes known as *accion subrogatoria* in Spanish Law, is different from legal and conventional subrogations mentioned in Article 1304 which involves a change of creditors. In *accion subrogatoria,* the creditor exercises the rights of the debtor in the latter's name.

[23]This remedy is called *accion pauliana* in Spanish Law. It is essential that the creditor has no other legal remedy to satisfy his claim against his debtor. (see Art. 1389.)

[24]*Under the Civil Code:*

Art. 1708. The laborer's wages shall not be subject to execution or attachment, except for debts incurred for food, shelter, clothing and medical attendance.

*Under the Family Code:*

Art. 155. The family home shall be exempt from execution, forced sale or attachment except:

(1) For non-payment of taxes;

(2) For debts incurred prior to the constitution of the family home;

(3) For debts secured by mortgages on the premises before or after such constitution; and

(4) For debts due to laborers, mechanics, architects, builders, materialmen and others who have rendered service or furnished material for the construction of the building. (243a)

Art. 157. The actual value of the family home shall not exceed, at the time of its constitution, the amount of Three hundred thousand pesos in urban areas, and Two hundred thousand pesos in rural areas, or such amounts as may hereafter be fixed by law.

In any event, if the value of the currency changes after the adoption of this Code, the value most favorable for the constitution of a family home shall be the basis of evaluation.

For purposes of this Article, urban areas are deemed to include chartered cities and municipalities whose annual income at least equals that legally required for chartered cities. All others are deemed to be rural areas. (231a)

Art. 160. When a creditor whose claim is not among those mentioned in Article 155 obtains a judgment in his favor, and he has reasonable grounds to believe that the family home is actually worth more than the maximum amount fixed in Article 157, he may apply to the court which rendered the judgment for an order directing the sale of the property under execution. The court shall so order if it finds the actual value of the family home exceeds the maximum amount allowed by law as of the time of its constitution. If the increased actual value exceeds the maximum allowed in Article 157 and results from subsequent voluntary improvements introduced by the person or persons constituting the family home, by the owner or owners of the property, or by any of the beneficiaries, the same rule and procedure shall apply.

At the execution sale, no bid below the value allowed for a family home shall be considered. The proceeds shall be applied first to the amount mentioned in Article 157, and then to the liabilities under the judgment and the costs. The excess, if any, shall be delivered to the judgment debtor. (247a, 248a)

*Under Rule 39 of the Rules of Court:*

Sec. 13. *Property exempt from execution.* — Except as otherwise expressly provided by law, the following property, and no other, shall be exempt from execution:

(a) The judgment obligor's family home as provided by law, or the homestead in which he resides, and land necessarily used in connection therewith;

(b) Ordinary tools and implements personally used by him in his trade, employment, or livelihood;

(c) Three horses, or three cows, or three carabaos, or other beasts of burden, such as the judgment obligor may select necessarily used by him in his ordinary occupation;

(d) His necessary clothing and articles for ordinary personal use, excluding jewelry;

(e) Household furniture and utensils necessary for housekeeping, and used for that purpose by the judgment obligor and his family, such as the judgment obligor may select, of a value not exceeding One hundred thousand pesos;

(f) Provisions for individual or family use sufficient for four months;

(g) The professional libraries and equipment of judges, lawyers, physicians, pharmacists, dentists, engineers, surveyors, clergymen, teachers, and other professionals, not exceeding Three hundred thousand pesos in value;

(h) One fishing boat and accessories not exceeding the total value of One hundred thousand pesos owned by a fisherman and by the lawful use of which he earns his livelihood;

(i) So much of the salaries, wages, or earnings of the judgment obligor for his personal services within the four months preceding the levy as are necessary for the support of his family;

(j) Lettered gravestones;

(k) Monies, benefits, privileges, or annuities accruing or in any manner growing out of any life insurance;

EXAMPLE:

On the due date, D could not pay C his obligation in the amount of P300,000.00. However, D owns a car worth about P160,000.00 and X is indebted to him for P40,000.00. Before the due date of the obligation, D sold his land worth P200,000.00 to Y.

Under the circumstances, the rights granted to C under the law are as follows:

(a) He may bring an action for the collection of the amount of P300,000.00 with the right to damages.

(b) If, inspite of the judgment rendered, D fails to pay the amount due, C can ask for the attachment of D's car so that the car may be sold and payment made from the proceeds of the sale.

(c) He may ask the court to order X not to pay D so that payment may be made to him (C).

(d) He may ask the court to rescind or cancel the sale made by D to Y on the ground that the transaction is fraudulent in case he (C) cannot recover in any other manner his credit. Note that this last remedy can be resorted to only if C could not collect in full his credit. (see Arts. 1381[3], 1387.) He must first exhaust the properties of the debtor or subrogate himself in the latter's transmissible rights and actions.

ILLUSTRATIVE CASE:

*Right of surviving spouse to representation in proceedings for settlement of deceased spouse's estate after sale of her interests in said estate.*

*Facts:* The share of W in the estate of her deceased husband, including a real property, was sold by the deputy sheriff under an execution issued on a judgment against W in favor of X. The sheriff's certificate of sale purported to convey not only the real estate but all the shares, actions, or interest of any kind which W might have in the estate of her deceased husband, including usufructuary and conjugal rights.

X contends that by virtue of the sale he is entitled not only to appear as the owner of the property in the proceedings for the settlement

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(l) The right to receive legal support, or money or property obtained as such support, or any pension or gratuity from the Government;

(m) Properties specially exempted by law.

But no article or species of property mentioned in this section shall be exempt from execution issued upon a judgment recovered for its price or upon a judgment of foreclosure of a mortgage thereon. (12a)

of her deceased husband's estate but also to exclude W from further participation therein.

*Issue:* Did the sale subrogate X to all the rights of W in the estate?

*Held:* No. In the real estate at least, W retained the right of redemption from the execution sale (see Sec. 29, Rule 39, Rules of Court.) which gave her a standing in the estate proceedings. Moreover, the creditor is not clothed with such rights as inherent in the person of his debtor and in this case, W's strictly personal rights would have alone entitled her to a representation in the estate proceedings. The existence of the right of redemption would suffice to prevent an entire subrogation. *(In re Estate of Ceballos, 12 Phil. 271 [1908].)*

**ART. 1178. Subject to the laws, all rights acquired in virtue of an obligation are transmissible, if there has been no stipulation to the contrary. (1112)**

## Transmissibility of rights.

All rights acquired in virtue of an obligation are generally transmissible. (see Art. 1311.) The exceptions to this rule are the following:

(1) *Prohibited by law.* — When prohibited by law, like the rights in partnership, agency, and *commodatum* which are purely personal in character.

(a) By the *contract of partnership,* two or more persons bind themselves to contribute money, property or industry to a common fund, with the intention of dividing the profits among themselves. (Art. 1767.)

(b) By the *contract of agency,* a person binds himself to render some service or to do something in representation or on behalf of another, with the consent or authority of the latter. (Art. 1868.)

(c) By the *contract of commodatum,* one of the parties delivers to another something not consumable so that the latter may use the same for a certain time and return it. *Commodatum* is essentially gratuitous. (Art. 1933.)

(2) *Prohibited by stipulation of parties.* — When prohibited by stipulation of the parties, like the stipulation that upon the death of the creditor, the obligation shall be extinguished or that the creditor cannot assign his credit to another. The stipulation against transmission must not be contrary to public policy. (see Art. 1306.) Such stipulation, being

contrary to the general rule, should not be easily implied, but must be clearly proved, or at the very least, clearly inferable from the provisions of the contract itself. (Estate of K.H. Hernandez vs. Luzon Surety Co., 100 Phil. 388 [1956].)

The assignment of credits and other incorporeal rights are governed by Articles 1624 to 1635 under Title VI (Sales).

ILLUSTRATIVE CASE:

*Transmissibility of option of lessee to buy leased property in the absence of contrary stipulation.*

*Facts:* R (owner) leased his factory to E (lessee) for two (2) years, giving the latter an option to buy said factory within the same period.

E assigned his right to X who communicated in writing his desire to exercise the option to R who, however, refused to execute the corresponding deed of sale alleging as his reason the fact that the option was given to E and not to any other person and E could not make the assignment without his (R's) consent and when E did it, he (R) withheld his approval.

*Issue:* Under the contract and the law, is there any impediment on the part of E to transfer his right under the option?

*Held:* No. The contract does not contain any stipulation forbidding E from assigning the option or requiring R's consent for the assignment. Nor was the option given to E in consideration of his personal qualifications. Article 1178 is applicable. *(Bastida and Ysmael & Co., Inc. vs. Dy Buncio & Co., Inc., 93 Phil. 195 [1953].)*

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# Chapter 3

# DIFFERENT KINDS OF OBLIGATIONS

**Classifications of obligations.**

(1) *Primary classification of obligations under the Civil Code:*

(a) Pure and conditional obligations (Arts. 1179-1192.);

(b) Obligations with a period (Arts. 1193-1198.);

(c) Alternative (Arts. 1199-1205.) and facultative obligations (Art. 1206.);

(d) Joint and solidary obligations (Arts. 1207-1222.);

(e) Divisible and indivisible obligations (Arts. 1223-1225.); and

(f) Obligations with a penal clause. (Arts. 1226-1230.)

(2) *Secondary classification of obligations under the Civil Code:*

(a) Unilateral and bilateral obligations (Arts. 1169-1191.);

(b) Real and personal obligations (Arts. 1163-1168.);

(c) Determinate and generic obligations (Art. 1165.);

(d) Civil and natural obligations (Art. 1423.); and

(e) Legal, conventional, and penal obligations. (Arts. 1157, 1159, 1161.)

(3) *Classification of obligations according to Sanchez Roman:*

(a) By their juridical quality and efficaciousness:

1) Natural. — according to natural law;

2) Civil. — according to civil law; and

3) Mixed. — according to both natural and civil law.

(b) By the parties or subject:

1) unilateral or bilateral;

2) individual or collective (see Arts. 1207, 1208.); and

3) joint or solidary.

(c) By the object of the obligation or prestation:

1) specific or generic;

2) positive or negative (see Art. 1168.);

3) real or personal;

4) possible or impossible (see Arts. 1183, 1306.);

5) divisible or indivisible;

6) principal or accessory (see Art. 1226.); and

7) simple or compound (see Art. 1199.); if compound, it may be:

a) conjunctive. — demandable at the same time; or

b) distributive. — either alternative or facultative.

(d) By their juridical perfection and extinguishment:

1) Pure or conditional; and

2) With a period. (Vol. 8, pp. 20-24.)

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# SECTION 1. — *Pure and Conditional Obligations*

**ART. 1179. Every obligation whose performance does not depend upon a future or uncertain event, or upon a past event unknown to the parties, is demandable at once.**

**Every obligation which contains a resolutory condition shall also be demandable, without prejudice to the effects of the happening of the event. (1113)**

## Meaning of pure obligation.

A *pure obligation* is one which is not subject to any condition and no specific date is mentioned for its fulfillment and is, therefore, immediately demandable.

EXAMPLES:

(1) D obliges to pay C P10,000.00. The obligation is immediately demandable if there is no condition and no date is mentioned for its fulfillment. Of course, if the loan has just been contracted by D, a period must have been intended by the parties for performance (see Floriano vs. Delgado, 11 Phil. 154 [1908].) but the duration thereof will depend upon the nature of the obligation and the circumstances. (Art. 1197.)

A distinction must be made between the immediate demandability of a pure obligation and its fulfillment by the obligor who may be granted by the court a reasonable period for performance. The period remains pure even where such period is fixed by the court.

(2) D promises to pay C P26,900.00 upon receipt by D of his share from the estate of X or "upon demand of C." The obligation of D is immediately due and demandable, for C may rely on the wording "upon demand." (Pay vs. Vda. de Palanca, 57 SCRA 18 [1974].)

## Meaning of conditional obligation.

A *conditional obligation* is one whose consequences are subject in one way or another to the fulfillment of a condition.

**Meaning of condition.**

*Condition* is a future and uncertain event, upon the happening of which, the effectivity or extinguishment of an obligation (or rights) subject to it depends.

**Characteristics of a condition.**

(1) *Future and uncertain.* — In order to constitute an event a condition, it is not enough that it be future; it must also be uncertain. The first paragraph of Article 1179 obviously uses the disjunctive *or* between "future" and "uncertain" to distinguish pure obligation from both the conditional obligation and one with a period. Be that as it may, the word "or" should be "and."

(2) *Past but unknown.* — A condition may refer to a past event unknown to the parties. *(infra.)* If it refers to a future event, both its very occurrence and the time of such occurrence must be uncertain; otherwise, it is not a condition.

A condition must not be impossible. (see Art. 1183.)

**Two principal kinds of condition.**

They are:

(1) *Suspensive condition (condition precedent* or *condition antecedent)* or one the fulfillment of which *will give rise* to an obligation (or right). In other words, the demandability of the obligation is suspended until the happening of a future and uncertain event which constitutes the condition.

(a) Actually, the birth, perfection or effectivity of the contract subject to a condition can take place only if and when the condition happens or is fulfilled. If the suspensive condition does not take place, the parties would stand as if the conditional obligation had never existed. (Gaite vs. Fonacier, 2 SCRA 830 [1961]; Joven vs. Court of Appeals, 183 SCRA 171 [1990]; Cheng vs. Genato, 300 SCRA 722 [1998]; Gonzales vs. Heirs of Thomas and Paula Cruz, 314 SCRA 585 [1999]; Insular Life Assurance Co., Ltd. vs. Toyota Bel-Air, Inc., 550 SCRA 70 [2008].)

(b) It must appear that the performance of an act or the happening of an event was intended by the parties as a suspensive condition, otherwise, its non-fulfillment will not prevent the

perfection of a contract. (see Arts. 1305, 1315, 1319.) Thus, where there is no provision in a contract of sale declaring it without effect until after the opening of a letter of credit by the buyer as required by the seller, the omission to so open does not prevent the perfection of the contract, such opening being only a mode of payment and is not among the essential requirement of a contract of sale enumerated in Articles 1305 and 1475.[1] (Johannes Schuback & Sons vs. Court of Appeals,[2] 227 SCRA 717 [1993].)

(c) There can be no rescission (see Art. 1191.) of an obligation that is still non-existent, the suspensive condition not having been fulfilled. (Luzon Brokerage Co., Inc. vs. Maritime Building Co., Inc., 46 SCRA 381 [1972]; Rillo vs. Court of Appeals, 274 SCRA 461 [1997]; Gonzales vs. Heirs of Thomas and Paul Cruz, *supra;* Padilla vs. Paredes, 328 SCRA 434 [2000].)

ILLUSTRATIVE CASES:

1. *Acknowledgment signed by one of the debtors of a document is conditioned upon the same being signed by all the debtors.*

*Facts:* By agreement of C and D, the separate debts of the brothers A, B, and C to D were liquidated and consolidated into only one obligation in a promissory note signed by C who acknowledged his indebtedness. D signed the note on condition that C would obtain the signatures of A and B thereby creating a joint obligation against the three. C never secured their signatures until his death.

In an action against A and B by D to recover their respective shares in the indebtedness, A and B contended that since their signatures were not affixed to the document, D was bound to acknowledge it as a credit only against C who signed it.

*Issue:* Is D bound to acknowledge the document as a credit only against C?

*Held:* No. The contract contained reciprocal obligations (see Art. 1169, last par.) which were to be fulfilled by each of the signers, that is, on the part of C to secure signatures of A and B to the instrument, and

[1]Art. 1475. The contract of sale is perfected at the moment there is a meeting of minds upon the thing which is the object of the contract and upon the price.

From that moment, the parties may reciprocally demand performance, subject to the provisions of the law governing the form of contracts. (1450a)

[2]See this case under Article 1319.

then on the part of D, to recognize it as a joint obligation of A, B, and C covering their indebtedness to him.

Until C obtained the signatures of A and B, D was not in any way bound to acknowledge it as anything more than an executory contract containing a condition precedent which was to be performed by C before D's obligation was due. Mere continued silence on his part could signify nothing until the signatures of A and B had been secured. *(Martinez vs. Cavives, 25 Phil. 581 [1913].)*

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2. *Sale of vessel is conditioned upon proof that seller is, in fact, owner of property.*

*Facts:* S, owner, and B, purchaser, agreed upon the sale of a vessel provided that the title papers to the same were in proper form. The title was in the name of another and S promised to perfect his title to the vessel. Before compliance by S with the condition exacted by B, and while the vessel was in S's possession, it sank due to a severe storm.

*Issue:* Is B under obligation to pay the price of the vessel?

*Held:* No. The sale of the vessel was not perfected, because of the non-compliance by S of a condition precedent to its perfection, to wit: the production of the proper papers showing that he was, in fact, the owner of the vessel in question. Consequently, the loss of the vessel must be borne by S, the owner, and not by B who only intended to purchase it and was unable to do so because of failure of S to comply with the said condition. Article 1262 is not applicable. *(Roman vs. Grimalt, 6 Phil. 96 [1906]*; see Borromeo vs. Franco, 5 Phil. 49 [1905], *infra.)*

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3. *Condition claimed was not contemplated by the parties.*

*Facts:* B obliged himself to pay S the balance of the purchase price of a subdivision lot within two years from the completion by S of the roads therein. S brought suit to foreclose the real estate mortgage executed by B to secure the payment of the unpaid price, for failure of B to pay the mortgage indebtedness notwithstanding the completion of the roads, a condition for the payment of the same.

B contends that the roads are not yet completed in the technical, legal sense, because the final say or acceptance by the Capital City Planning Commission of Quezon City had not yet been secured.

*Issue:* Is this contention of B tenable?

*Held:* No. This contention is inordinately technical and also devoid of merit. There is nothing at all in the ordinance (No. 2969 of Quezon City)

which makes the acceptance by the said agency a condition precedent before a street may be considered constructed. Such condition was not within the contemplation of the parties. *(Enriquez vs. Ramos, 73 SCRA 116 [1976].)*

(2) *Resolutory condition (condition subsequent)* or one the fulfillment of which will *extinguish* an obligation (or right) already existing.

ILLUSTRATIVE CASES:

1. *Donation subject to resolutory condition transfers title but revocable for non-compliance with condition.*

*Facts:* R donated to T (Province of Tarlac) a parcel of land subject to the condition that it was to be used for the erection of a central school and a public park, the work to commence within the period of six (6) months from the date of the ratification by the parties of the deed of donation. The donation was accepted by T and title to the property was transferred to it. Subsequently, R sold the land to C.

C claimed that since the condition imposed was not complied with, there was no donation.

*Issue:* Is the condition suspensive or subsequent?

*Held:* It is a condition subsequent. The characteristic of a condition precedent is that the acquisition of right is not effected while said condition is not complied with or is not deemed complied with. Meanwhile, nothing is acquired and there is only an expectancy of right. Consequently, when a condition is imposed, the compliance of which cannot be effected except when the right is deemed acquired, such condition cannot be deemed a condition precedent.

In the present case, the condition could not be complied with except after giving effect to the donation. The donee could not do any work on the donated land if the donation had not really been effected because it would be an invasion of another's title, for the land would have continued to belong to the donor so long as the condition imposed was not complied with. The non-compliance with the condition is, however, a sufficient cause for revocation. *(Parks vs. Prov. of Tarlac, 49 Phil. 142 [1926].)*

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2. *Transfer of ownership of property sold shall become absolute upon payment by vendee of vendor's debt to third parties; void, if paid by the vendor himself.*

*Facts:* S sold to B a parcel of land in consideration of the obligation assumed by B to pay what the vendor (S) owed to several parties mentioned in the deed; if S paid his debts, the sale shall become inoperative

and void, but that if B paid the same debts by reason of S's failure to do so, the sale made shall become absolute and irrevocable automatically, without the need of executing any other deed of conveyance. B paid the debts of S.

Upon presentation of the corresponding instruments, the certificate of title issued in the name of S was cancelled and a transfer certificate of title was issued in B's name.

*Issue:* Is the contract one of equitable mortgage or a sale subject to a resolutory condition?

*Held:* The contract is obviously a perfected contract of sale and subject to a resolutory condition. The property is not given as a mere security for a loan — which is the manifest purpose of a contract of mortgage — but instead it makes a conditional transfer of ownership which becomes automatically absolute and final upon performance of the condition agreed upon, namely, payment by B of what S owed the parties mentioned in the deed of conveyance. *(Rodriguez, Sr. vs. Francisco, 2 SCRA 648 [1961].)*

*Note*: In a contract to sell on installments, upon the fulfillment of the positive suspensive condition which is the full payment of the purchase price, ownership will not automatically transfer to the buyer although the property may have been previously delivered to him. The prospective seller still has to convey title to the prospective buyer by entering into a contract of absolute sale. (see Coronel vs. Court of Appeals, 263 SCRA 15 [1996].) The failure to fulfill the condition is not considered a breach, casual or serious, but simply an event which prevents the obligation of the seller to convey title from acquiring any obligatory force. *(Rillo vs. Court of Appeals, 274 SCRA 461 [1997].)*

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3. *Vendor seeks rescission of sale for violation by vendee of restriction imposed in contract of sale between vendor and previous owner (first vendor).*

*Facts:* The contract of sale of three (3) lots between S (PHHC) and B provided that only construction exclusively for "residential purposes" shall be built on the property, terms thereof to be binding upon the successors and assignees of the respective parties. Subsequently, B sold two (2) lots to Meralco which established a sub-station within the property.

Because of the "severe noise" from the sub-station, B filed a complaint for the rescission of the sale.

*Issue:* Has B the right of action against Meralco for violation of the restriction imposed in the contract between S and B?

*Held:* No. It is S which has the right of action against any assignee of B. S cannot rescind the contract between B and Meralco because it was not a party to it. S's redress would be to directly "seek cancellation of the title of Meralco, and to repossess the property" as provided in its contract with B. *(Manila Electric Company vs. Court of Appeals, 114 SCRA 173 [1982].)*

**Distinctions between suspensive and resolutory conditions.**

The difference between the two conditions is very clear; both bear an influence on the existence of the obligation, but in diametrically opposed manner.

(1) If the suspensive condition is fulfilled, the obligation arises, while if it is the resolutory condition that is fulfilled, the obligation is extinguished;

(2) If the first does not take place, the tie of law (juridical or legal tie) does not appear, while if it is the other, the tie of law is consolidated; and

(3) Until the first takes place, the existence of the obligation is a mere hope, while in the second, its effects flow, but over it, hovers the possibility of termination. (see 8 Manresa 130-131.)

*Note:* A distinction must be made between a condition imposed on the perfection of a contract and that imposed on the performance of an obligation. Failure to comply with the first condition results in the failure of a contract, while failure to comply with the second (*e.g.*, condition that the seller shall eject the squatters on the property sold within a certain period), only gives the other party the option either to refuse to proceed with the sale or to waive the condition. (Lim vs. Court of Appeals, 263 SCRA 569 [1996]; see Art. 1545; Babasa vs. Court of Appeals, 290 SCRA 532 [1998]; Jardine Davies, Inc. vs. Court of Appeals, 333 SCRA 684 [2000].)

**When obligation demandable at once.**

An obligation is demandable at once —

(1) when it is pure (Art. 1179, par. 1.);

(2) when it is subject to a resolutory condition (*Ibid.*, par. 2.); or

(3) when it is subject to a resolutory period. (Art. 1193, par. 2.)

### Past event unknown to the parties.

A condition really refers only to an uncertain and future event. A past event cannot be said to be a condition since the demandability of an obligation subject to a condition depends upon whether the event will happen or will not happen.

What is really contemplated by the law is the knowledge to be acquired in the future of a past event which at the moment is unknown to the parties interested, for it is only in that sense that the event can be deemed uncertain. This knowledge determines whether the obligation will arise or not. (see 8 Manresa 120-121.)

EXAMPLE:

S is the owner of a parcel of land which is being claimed by X. Last week, the Supreme Court has rendered a final decision upholding the right of S. However, S has not yet received the notice that he had won the case. Now, S obliged himself to sell the land to B for a definite price, should he win the case against X.

Under the facts, S would be bound to sell the land to B upon receipt of the notice that he had won the case against X.

**ART. 1180. When the debtor binds himself to pay when his means permit him to do so, the obligation shall be deemed to be one with a period, subject to the provisions of Article 1197. (n)**

### Where duration of period depends upon the will of debtor.

A *period* is a future *and* certain event upon the arrival of which the obligation subject to it either arises or is extinguished.

(1) *The debtor promises to pay when his means permit him to do so.* — The obligation shall be deemed to be one with a period. In this case, what depends upon the debtor's will is not whether he should pay or not for indeed he binds himself to pay. What is left only to his will is the duration of the period. If the debtor and the creditor cannot agree as to the specific time for payment, the court shall fix the same on the application of either party. (Art. 1197, par. 2.)

(2) *Other cases.* — As when the debtor binds himself to pay:

(a) "little by little" (Seone vs. Francisco, 24 Phil. 309 [1913].);

(b) "as soon as possible" (Gonzales vs. Jose, 66 Phil. 369 [1938].);

(c) "from time to time;"

(d) "as soon as I have the money" (Patente vs. Omega, 93 Phil. 218 [1958].);

(e) "at any time I have the money" (Soriano vs. Abalos, 84 Phil. 206 [1949].);

(f) "in partial payments" (Levy Hermanos vs. Paterno, 18 Phil. 353 [1911].); and

(g) "when I am in a position to pay." (see Luding Hahn vs. Lazatin, 1911 [Unrep.], 105 Phil. 135, 891 [1959].)

Obligations with a period are discussed in the next Section. (Arts. 1193-1198.)

**ART. 1181. In conditional obligations, the acquisition of rights, as well as the extinguishment or loss of those already acquired, shall depend upon the happening of the event which constitutes the condition. (1114)**

## Effect of happening of condition.

This article reiterates the distinction between a suspensive (or antecedent) condition and a resolutory (or subsequent) condition.

(1) *Acquisition of rights.* — In obligations subject to a suspensive condition, the acquisition of rights by the creditor depends upon the happening of the event which constitutes the condition.

What characterizes this kind of obligation is the fact of its efficacy or obligatory force (as distinguished from its demandability) is subordinated to the happening of a future and uncertain event; so that if the suspensive condition does not take place, the parties would stand as if the conditional obligation had never existed (Gaite vs. Fonacier, 2 SCRA 831 [1961].), or before the suspensive condition has taken place, what is acquired by the creditor is a mere hope or expectancy of acquiring a right. (see Art. 1188, par. 1.)

(a) The surrender of the sweepstakes ticket is a condition precedent to the payment of the prize. (Santiago vs. Millar, 68 Phil. 39 [1939].)

(b) Where the loans of X from Y were supposed to become due only at the time Y receives from Z the proceeds of the approved financing scheme, and Z refused to make releases, the condition for the loan did not happen and X is not, therefore, liable to Y. (Rose Packing Corp., Inc. vs. Court of Appeals, 167 SCRA 309 [1988].)

(c) In sales with assumption of mortgage, the assumption of mortgage by the buyer is a condition precedent to the seller-mortgagor's consent to the sale, so that without approval by the mortgagee, no sale is perfected and the seller remains the owner and mortgagor of the property and as such retains the right to redeem the foreclosed property. (Ramos vs. Court of Appeals, 279 SCRA 118 [1997].)

ILLUSTRATIVE CASES:

1. *Right of owner to receive payment for use of his vessel is conditioned upon contract for lighterage being awarded to lessee by the government.*

*Facts:* X bound itself to pay a certain amount daily for the use of Y's lorchas during the period that they should be in X's possession and control, subject to the condition that X would succeed in securing the *entire* contract for lighterage from the Government. Said contract embraced two services: emergency and regular. X was able to secure only the emergency service, the regular service having been awarded to another.

After using the lorchas, X immediately notified Y and tendered payment corresponding to the days the lorchas were in use pursuant to said emergency service. The payment was refused by Y.

*Issue:* Is X liable for the days he did not use the lorchas while they were in his control?

*Held:* No. The obligation assumed by X was a conditional one. Since he was able to secure only a part of the lighterage services, his obligation to pay for all the days he had the lorchas in his control did not arise. *(Lichauco vs. Figueras Hnos, 7 Phil. 339 [1907].)*

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2. *Right of creditor to be paid by surety is conditioned upon failure of debtor to deliver to creditor proceeds of sales of merchandise purchased by debtor from creditor.*

*Facts:* D, as principal, and S, as surety, executed a promissory note in favor of C for the price of goods purchased by D from C, "upon condition that D will pay over to C at the end of each month all sums which he may

receive from the sale of said goods, and that in the contrary event, both (D and S) undertake to pay to C such sums as D may fail to turn in as above stated."

In an action by C to recover the amount of the promissory note, C did not prove that he has not, in fact, received all the money derived from the sale of the goods mentioned.

*Issue:* Is S liable on the note?

*Held:* No. S did not undertake absolutely to pay the indebtedness of D. His obligation was subject to a suspensive condition: the failure of D to deliver to C the total proceeds of the sales of the merchandise for the invoice value of which the note was given. That condition not having taken place, it follows that S had incurred no liability. *(Wise & Co. vs. Kelly and Lim, 37 Phil. 696 [1918].)*

(2) *Loss of rights already acquired.* — In obligations subject to a resolutory condition, the happening of the event which constitutes the condition produces the extinguishment or loss of rights already acquired.

EXAMPLES:

(1) S sold to B a parcel of land subject to S's right of repurchase. The ownership already acquired by B under the contract shall be extinguished or lost should S exercise his right of repurchase.

(2) A lease contract expressly stipulates that R, lessor, may terminate the lease in case his children shall need the leased premises. Here, the happening of the condition depends upon the will of a third person — R's children. (see Ducusin vs. Court of Appeals, 122 SCRA 280 [1983].)

(3) R (donor) donates land to E (donee) on the condition that the latter would build upon the land a school. The condition imposed is a resolutory one. If there is no compliance with the condition, R may revoke the donation and all rights which E may have acquired under it shall be deemed lost or extinguished. (Central Phil. University vs. Court of Appeals, 246 SCRA 511 [1995].)

ILLUSTRATIVE CASES:

1. *Right of a party to receive a share of profits of a company to be rehabilitated shall cease to exist upon his failure to advance the necessary funds within the period stipulated.*

*Facts:* X agreed to advance P75,000.00 for the rehabilitation of Y (mining Company) which had been completely destroyed by flood, for

which X was to receive a certain number of shares of the unissued stocks thereof, it being stipulated that the amount was to be paid to Y within six (6) months from the execution of the contract, and that upon default of either party, the obligation of the other shall be discharged.

X failed to raise the necessary funds. Y was able to secure the funds from other sources. It was rehabilitated and profits were realized.

*Issue:* Is X entitled to a share of said profits and to the issuance of shares of stock in accordance with the agreement?

*Held:* No. This is a typical case of a resolutory condition under the civil law. The contract expressly provides that upon the happening of a future and uncertain negative event, the obligation created by the agreement shall cease to exist. The right of X was expressly subordinated to a resolutory condition, to wit: his failure to raise the necessary funds within the period agreed upon. *(Hanlon vs. Hausserman and Beam, 40 Phil. 796 [1920].)*

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2. *Non-fulfillment of a mere incidental stipulation in a contract of sale.*

*Facts:* S agreed to sell a parcel of land to B. Under the contract, B was given a certain period within which to arrange and complete the papers relating to the property. S refused to proceed with the sale in view of the failure of B to complete the title papers.

B brought action for specific performance.

*Issue:* Is the agreement on the part of B to complete the title papers a condition subsequent?

*Held:* No, and, therefore, its non-fulfillment did not resolve the obligation of S to sell. It is a mere incidental stipulation which the parties saw fit to include in their agreement. *(Borromeo vs. Franco, 5 Phil. 49 [1905];* see Roman vs. Grimalt, 6 Phil. 96 [1906], *supra.)*

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3. *Right of possession of land shall terminate if any of owner's grandchildren decides to build house on property.*

*Facts:* X, owner of a residential lot, executed an agreement with Y under which X shall reap the fruits of the riceland of Y while Y shall have the right to build his house on the lot of X, subject to the condition that if any of the grandchildren of X decides to build his or her house on the lot, Y shall be obliged to return the same. Under the agreement, X and Y are prohibited to encumber or alienate their respective properties without the consent of the other.

C, a grandchild of X, now seeks to recover the property, claiming that he needs the same for the construction of his house thereon.

*Issue:* Is C entitled to recover the lot?

*Held:* Yes. The mutual agreement between X and Y — each party enjoying "material possession" of the other's property — is subject to a resolutory condition the happening of which has the effect of terminating the right of possession and use. The agreement indicates that there is no intention on the part of the parties to convey ownership of their respective properties. *(Baluran vs. Navarro, 79 SCRA 309 [1977].)*

### Effect of non-compliance with resolutory condition.

Where a contract is subject to a resolutory condition, non-compliance with or non-fulfillment of the condition resolves the contract by force of law without need of judicial intervention.

ILLUSTRATIVE CASES:

1. *Sale to be deemed cancelled upon failure to construct house on land sold within a certain period.*

*Facts:* PHHC (People's Homesite and Housing Corp.), a government instrumentality, sold a lot to B subject to the resolutory condition that B "shall construct a residential house on the lot within a period of one (1) year from the signing of the contract, non-compliance with which shall result in the contract being deemed annulled and cancelled."

B failed to comply with the condition of the contract.

*Issue:* What is the effect of B's non-compliance with the resolutory condition of building a house?

*Held:* The contract is resolved by operation of law. B acquires no vested right to the lot which reverts to PHHC. PHHC, however, may waive the effects of said resolutory condition. *(Bañez vs. Court of Appeals, 59 SCRA 15 [1974].)*

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2. *Sale is subject to two conditions and only one is fulfilled.*

*Facts:* S sold to B a parcel of land subject to the condition that B makes a down payment of P100,000.00 *and* that the Government accepts the bid of S to purchase Government property. B made the down payment which was accepted by S. However, the Government did not accept the bid of S.

*Issue:* Having accepted the down payment, is S bound to sell?

*Held:* No. Acceptance by S of the part payment of P100,000.00 shows that the sale was conditionally consummated or partly executed subject to the acceptance of S's bid by the Government. The non-acceptance of S's bid is in the nature of a negative resolutory condition. *(*see *Villonco Realty Co. vs. Bormacheco, Inc., 65 SCRA 352 [1975].)*

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3. *The land which was donated on the condition that it should be used exclusively for school purposes only was exchanged by the donee for a bigger land which was used for the same purpose.*

*Facts:* In the deed of donation executed by respondents spouses, they imposed the condition that the 5,600 square meter parcel of land should "be used exclusively and forever for school purposes only." This donation was accepted by the District Supervisor of the Bureau of Public Schools through an Affidavit of Acceptance and/or Confirmation of Donation.

The school building that was supposed to be allocated for the donated parcel of land could not be released since the government required that it be built upon a one (1) hectare parcel of land. To remedy this predicament, the District Supervisor and a lot owner entered into a deed of exchange whereby the donated lot was exchanged with a bigger lot owned by the latter. School buildings were constructed on the new site.

*Issue:* In exchanging the donated lot with a bigger lot, did the donee violate the condition in the donation?

*Held:* No. (1) *Meaning of terms.* — "What does the phrase 'exclusively used for school purposes' convey? 'School' is simply an institution or place of education. 'Purpose' is defined as "that which one sets before him to accomplish or attain; an end, intention, or aim, object, plan, project. Term is synonymous with the ends sought, an object to be attained, an intention, etc. 'Exclusive' means excluding or having power to exclude (as by preventing entrance or debarring from possession, participation, or use); limiting or limited to possession, control or use."

(2) *Purpose of donation remains the same.* — "Without the slightest doubt, the condition for the donation was not in any way violated when the lot donated was exchanged with another one. The purpose for the donation remains the same, which is for the establishment of a school. The exclusivity of the purpose was not altered or affected. In fact, the exchange of the lot for a much bigger one was in furtherance and enhancement of the purpose of the donation. The acquisition of the bigger lot paved the way for the release of funds for the construction of Bagong Lipunan school building which could not be accommodated

by the limited area of the donated lot." *(Republic vs. Silim, 356 SCRA 1 [2001].)*

**ART. 1182. When the fulfillment of the condition depends upon the sole will of the debtor, the conditional obligation shall be void. If it depends upon chance or upon the will of a third person, the obligation shall take effect in conformity with the provisions of this Code. (1115)**

## Classifications of conditions.

Conditions may be classified as follows:

(1) *As to effect.*

(a) *Suspensive.* — the happening of which gives rise to the obligation; and

(b) *Resolutory.* — the happening of which extinguishes the obligation.

(2) *As to form.*

(a) *Express.* — the condition is clearly stated; and

(b) *Implied.* — the condition is merely inferred.

(3) *As to possibility.*

(a) *Possible.* — the condition is capable of fulfillment, legally *and* physically; and

(b) *Impossible.* — the condition is not capable of fulfillment, legally *or* physically.

(4) *As to cause or origin.*

(a) *Potestative.* — the condition depends upon the will of one of the contracting parties;

(b) *Casual.* — the condition depends upon chance or upon the will of a third person; and

(c) *Mixed.* — the condition depends partly upon chance and partly upon the will of a third person.

(5) *As to mode.*

(a) *Positive.* — the condition consists in the performance of an act; and

(b) *Negative.* — the condition consists in the omission of an act.

(6) *As to number.*

(a) *Conjunctive.* — there are several conditions and all must be fulfilled; and

(b) *Disjunctive.* — there are several conditions and only one or some of them must be fulfilled.

(7) *As to divisibility.*

(a) *Divisible.* — the condition is susceptible of partial performance; and

(b) *Indivisible.* — the condition is not susceptible of partial performance.

**Meaning of potestative condition.**

A *potestative condition* is a condition suspensive in nature and which depends upon the sole will of one of the contracting parties.

**Where suspensive condition depends upon the will of debtor.**

(1) *Conditional obligation void.* — Where the potestative condition depends solely upon the will of the debtor, the conditional obligation shall be void because its validity and compliance is left to the will of the debtor (Art. 1308.) and it cannot, therefore, be legally demanded.[3] In order not to be liable, the debtor will not just fulfill the condition. There is no burden on the debtor and consequently, no juridical tie is created. (Art. 1156.)

[3]What may depend upon the exclusive will of the debtor is the time within which the condition shall be fulfilled. In a case, the condition imposed by the donor, *i.e.,* building of a medical school upon the land donated, depended upon the exclusive will of the donee as to when this condition shall be fulfilled. When the donee accepted the donation, it bound itself to comply with the condition thereof. It has been held that its absolute acceptance of the donation and acknowledgment of the obligation provided therein were sufficient to prevent the statute of limitations from barring the action of the donor upon the original contract which was the deed of donation. The starting point for bringing the action began with the expiration of a reasonable period and opportunity for the donee to fulfill what has been charged upon it by the donor. (Central Phil. University vs. Court of Appeals, 246 SCRA 511 [1995].)

EXAMPLES:

(1) "I will pay you if I want."

(2) "I will pay you after I receive a loan from a bank." (Berg vs. Magdalena Estate, Inc., 92 Phil. 110 [1953].)

(3) "I will pay you after I recover what D owes me."

(4) "I will pay you after I have harvested fish." (Trillana vs. Quezon College, Inc., 93 Phil. 383 [1953].)

(5) "I will pay you upon the sale of the house in which I live." (Osmeña vs. Rama, 14 Phil. 99 [1909]; see Gaite vs. Fonacier, 2 SCRA 831 [1961], cited under Art. 1193.)

(6) "I will pay you the price of the forest concession you sold me upon my operation of the same." (Tible vs. Aquino, 65 SCRA 207 [1975].)

(7) The contract of lease provides that the lease shall continue "for as long as the lessee needed the premises and can meet and pay the 20% increase every three years." (Lao Lim vs. Court of Appeals, 191 SCRA 150 [1991].)

In all the above cases, both the conditions and the obligations are void. The conditions in examples Numbers 2 to 6 are tantamount to a debtor telling the creditor that he would pay his obligation when and if he wants. In example No. 7, the effectivity and fulfillment of the contract of lease depends exclusively upon the uncontrolled choice of the lessee.

ILLUSTRATIVE CASES:

1. *Validity of stipulation in a contract of employment that grant of bonus shall depend upon the discretion of the board of directors.*

*Facts:* On the basis of the stipulation inserted in the contract of employment that E would be entitled to such further amount in the way of bonus as the board of directors might see fit to grant, E contends that he is entitled to a bonus to be fixed by the court as a reasonable participation in the increased profits of the factory under his care.

*Issue:* What is the legal effect of the stipulation?

*Held:* A promise of this character creates a legal obligation binding upon the promissor, although in its actual results it may not infrequently prove to be illusory. Such promise is not nugatory, under Article 1182, as embodying a condition dependent exclusively upon the will of the obligor. Nor can it be held invalid under Article 1308 which declares that the validity and performance of a contract cannot be left to the will of one of the contracting parties.

The uncertainty of the amount to be paid by way of bonus is also no obstacle to the validity of the contract (see Article 1349.) since the contract itself specifies the manner in which the amount payable is to be determined, namely by the exercise of the judgment and discretion of the employer. *(Liebnow vs. Phil. Vegetable Oil Co., 39 Phil. 60 [1918].)*

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2. *Validity of stipulation that vendee shall pay the purchase price upon settlement by him of various debts encumbering his property.*

*Facts:* A deed of sale of a hacienda contains the following stipulation: "as soon as D has paid his debts to B and C, or to any other person or entity to whom D is in debt at present, or shall in future become indebted on account of the exploitation of the España Estate, D shall pay to E, the amount of P20,000.00 according to the following terms. x x x."

E brought action for the recovery of the purchase price, claiming that the stipulation is void.

*Issue:* Does the payment of the purchase price by the vendee (D) depends upon his will?

*Held:* No. In this case, the payment of the purchase price is conditioned upon the full settlement by D of the various debts encumbering the estate. "We must not lose sight of the fact that these debts were then so numerous and pressing that all of them exceeded the value of the property itself, with all its improvements making it practically worthless. Of course, the stipulation implied that D was under the obligation to liquidate them as soon as possible, applying all the products from the estate which could be disposed of to such payment.

Taking this stipulation in this sense, it cannot be said that the duty of paying P20,000.00 depended exclusively upon D's will. With those obligations upon him, and his own good intentions and earnest desire which must be presumed in the absence of evidence to the contrary, there are still other factors determining the payment of the aforementioned debts, factors as essential as they are independent of D's will, and subject to those difficulties and hindrances which attend the exploitation of a sugar plantation in the circumstances as shown by the record. Therefore, Article 1182 is not applicable to this case." *(Martin vs. Boyero, 55 Phil. 762 [1913].)*

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3. *Validity of stipulation that vendee shall pay the purchase price as soon as the occupants of the property sold have vacated the same.*

*Facts:* S (seller) filed an action for specific performance of a contract relating to the sale of a parcel of land with the improvements existing

thereon consisting of a residential house. The contract stipulates that the balance of P39,000.00 will be paid as soon as the premises have been vacated by the present occupants, with the further understanding that "the buyer will take care for the present occupants to vacate the place."

S contends that the contract is void because the fulfillment of the condition stipulated depends upon the exclusive will of the debtor.

*Issue:* Does the payment of the purchase price by the vendee (B) depends upon his will?

*Held:* No. S's contention is untenable. In the first place, should B for one reason or another show lack of interest in compelling the tenants to vacate the premises, as he agreed to do, there is nothing either in the contract or in the law that could have barred S from taking the necessary action to eject the tenants and thus compel B to pay the balance.

In the second place, should the tenants vacate the premises even without a demand, B's obligation to pay the balance would have arisen unavoidably. It is clear, therefore, that although the fulfillment of the condition depended partly upon the will of B, it likewise depended upon the will of S (obligee) himself and partly upon the tenants. Consequently, the contract is valid. *(Jacinto vs. Chua Leng, [C.A.] 45 O.G. 2919.)*

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4. *Validity of stipulation that vendee shall pay the purchase price after he has obtained a loan.*

*Facts:* S offered to sell his undivided share in a property known as Crystal Arcade to B who accepted the offer. It was agreed that the purchase price shall be paid by B after he has obtained a loan from a bank or funds from other sources.

*Issue:* Is the fulfillment of the condition for payment dependent upon B's exclusive will?

*Held:* Yes. Consequently, S's obligation to sell did not arise. Under the terms of the agreement, there is no legal way by which S could be compelled to carry out his agreement to sell. *(Berg vs. Magdalena Estate, Inc., 92 Phil. 110 [1953].)*

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5. *Validity of stipulation under a building contract that in case of increase of cost of project, "the owner shall equitably make the appropriate adjustment on mutual agreement of the parties."*

*Facts:* Private respondent YF was contracted by petitioner SBTC to construct the latter's bank building in Davao City for the price of P1,760,000. The construction was finished within the contracted period

but YF was compelled by a drastic increase in the cost of construction materials to incur expenses of about P300,000 on top of the original cost SBTC had the increased cost evaluated and audited.

When private respondent demanded payment of P259,417.23, petitioner's YF's Vice-President and the bank's architectural consultant were directed by the bank to verify and compute YF's claims of increased cost. A recommendation was then made to settle YF's claim for P200,000.00. Despite this recommendation and several demands from private respondent, SBTC failed to make payment. It denied authorizing anyone to make a settlement of YF's claim and likewise denied any liability contending that *the absence of a mutual agreement made YF's demand premature and baseless.*

It is not denied that private respondent incurred additional expenses in constructing petitioner bank's building due to a drastic and unexpected increase in construction cost. In fact, petitioner bank admitted liability for increased cost when a recommendation was made to settle private respondent's claim for P200,000.00. YF's claim for the increased amount was adequately proven during the trial by receipts, invoices and other supporting documents.

SBTC likewise denied any liability for the additional cost based on Article IX of the building contract which states:

> "If at any time prior to the completion of the work to be performed hereunder, increase in prices of construction materials and/or labor shall supervene through no fault on the part of the contractor whatsoever or any act of the government and its instrumentalities which directly or indirectly affects the increase of the cost of the project. OWNER shall equitably make the appropriate adjustment on mutual agreement of both parties."

It argued that since there was no mutual agreement between the parties, petitioners' obligation to pay amounts above the original contract price never materialized.

*Issue:* Is SBTC liable for the additional cost based on Article IX of the building contract?

*Held:* In the present case, SBTC's arguments to support absence of liability for the cost of construction beyond the original contract price are not persuasive.

(1) *Condition for SBTC's liability dependent on its sole will.* — "Under Article 1182 of the Civil Code, a conditional obligation shall be void if its fulfillment depends upon the sole will of the debtor. In the present case, the mutual agreement, the absence of which petitioner bank relies

upon to support its non-liability for the increased construction cost, is in effect a condition dependent on petitioner bank's sole will, since private respondent would naturally and logically give consent to such an agreement which would allow him recovery of the increased cost."

(2) *SBTC's non-liability would result in unjust enrichment.* — "Further, it cannot be denied that petitioner bank derived benefits when private respondent completed the construction even at an increased cost.

Hence, to allow petitioner bank to acquire the constructed building at a price far below its actual construction cost would undoubtedly constitute unjust enrichment for the bank to the prejudice of private respondent. Such unjust enrichment, as previously discussed, is not allowed by law."

Article 22 of the Civil Code which embodies the maxim, *Nemo ex alterius incommodo debet lecupletari* (no man ought to be made rich out of another's injury) states:

> 'Art. 22. Every person who through an act of performance by another, or any other means, acquires or comes into possession of something at the expense of the latter without just or legal ground, shall return the same to him.'

The above-quoted article is part of the chapter of the Civil Code on Human Relations, the provisions of which were formulated as "basic principles to be observed for the rightful relationship between human beings and for the stability of the social order, x x x designed to indicate certain norms that spring from the fountain of good conscience, x x x guides for human conduct [that] should run as golden threads through society to the end that law may approach its supreme ideal which is the sway and dominance of justice." *(Security Bank & Trust Company vs. Court of Appeals, 249 SCRA 206 [1995].)*

(2) *Only the condition void.* — If the obligation is a pre-existing one, and, therefore, does not depend for its existence upon the fulfillment by the debtor of the potestative condition, only the condition is void leaving unaffected the obligation itself. Here, the condition is imposed not on the birth of the obligation but on its fulfillment.

EXAMPLE:

D borrowed P10,000.00 from C payable within two (2) months. Subsequently, D promised to pay C "after D sells his car" to which C agreed. In this case, only the condition is void but not the pre-existing obligation of D to pay C.

**Where suspensive condition depends upon the will of creditor.**

If the condition depends exclusively upon the will of the creditor, the obligation is valid.

EXAMPLE:

"I will pay you my indebtedness upon your demand."

The obligation does not become illusory. Normally, the creditor is interested in the fulfillment of the obligation because it is for his benefit. It is up to him whether to enforce his right or not.

**Where resolutory condition depends upon the will of debtor.**

If the condition is resolutory in nature, like the right to repurchase in a sale with *pacto de retro,* the obligation is valid although its fulfillment depends upon the sole will of the debtor. The fulfillment of the condition merely causes the extinguishment or loss of rights already acquired. (Art. 1181.) The debtor is naturally interested in its fulfillment.

The position of the debtor when the condition is resolutory is exactly the same as that of the creditor when the condition is suspensive.

A condition which is both potestative (or facultative) and resolutory may be valid, even though the condition is left to the will of the obligor. (Rustan Pulp & Paper Mills, Inc. vs. Intermediate Appellate Court, 214 SCRA 665 [1992]; Taylor vs. Uy Tieng, *infra*.)

ILLUSTRATIVE CASES:

1. *Validity of stipulation in a contract of employment that a contract may be cancelled by the employer in case of non-arrival within a certain period of a specific machinery for a contemplated factory.*

*Facts:* R contracted the services of E as superintendent of an oil factory which the former contemplated establishing. At the time this agreement was made, the machinery for the contemplated factory had not been acquired. A provision in the contract is as follows:

"It is understood and agreed that should the machinery to be installed in the said factory fail, for any reason, to arrive in the City of Manila, within a period of six months from date hereof, this contract may be cancelled by the party of the second part (R) at its option,

such cancellation, however, not to occur before the expiration of six months."

The machinery did not arrive.

*Issue:* Is the condition obnoxious to the first sentence contained in Article 1182?

*Held:* No. The condition is valid even though it is made to depend upon the will of the obligor (R) as it is resolutory in nature. R would be liable even in the absence of proof showing that the non-arrival was due to some cause not having its origin in R's own act or will if he were under a positive obligation to cause the machinery to arrive. The contract, however, expresses no such positive obligation. *(Taylor vs. Uy Tieng, 43 Phil. 873 [1922].)*

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2. *After the expiration of its porterage contract with the Manila International Airport, the porterage contractor was informed in a letter of the MIA Authority General Manager that it may "continue operating said service until further notice from us."*

*Facts:* K Services began providing porters for the domestic passenger terminal of the Manila (now Ninoy Aquino) International Airport under a provisional permit that was renewed until December 1984. Although the parties did not review their contract for the succeeding year, K Services continued as porterage contractor. K Services received a letter from the then MIAA General Manager, the relevant portion of which stated: "Due the certain administrative problems, that are preventing us from taking over, please continue operating said service *until further notice from us*."

K Services alleged that it was initially hesitant to accept MIAA's offer. However, it continued to provide porters for Domestic Terminal I and expanded its operations to cover Domestic Terminal II upon the alleged verbal assurance of MIAA's officers that MIAA's policy was to relinquish porterage operations to the private sector. K Services likewise claimed that MIAA officers also gave verbal assurance that K Services would not be replaced with another porterage contractor without a public bidding in which K Services could participate.

On December 1, 1992, the new General Manager gave written notice to K Services to "wind up" its operations as "Management has decided to take over the aforecited services at the Domestic Passenger Terminals I and II."

K Services opposed the takeover. It filed a petition for prohibition with preliminary injunction.

*Issue:* Whether K Services was entitled to the writ of preliminary injunction granted by the trial court.

*Held:* No. (1) *Extension would only be "until further notice."* — "While it may be conceded that private respondent was allowed to continue operating the porterage service after the expiration of the contract as the above letter shows, there is no question, however, that private respondent was only allowed to operate up to a certain time, specified therein as 'until further notice from us.' Indeed, there is nothing in said letter to indicate that private respondent has until forever to operate the porterage service as private respondent would like to make it appear. The fact that the authority to continue the porterage service was specified up to a certain period is a clear indication that petitioner did not intend to allow private respondent to operate the porterage service for as long as it pleases. Perforce, it limited such privilege to a certain period or until further notice."

(2) *Phrase provided a resolutory facultative condition.* — "Where the terms of a contract are clear, leaving no doubt on the intention of the contracting parties, the Court has held that the literal meaning of the stipulations shall control.The phrase 'until further notice' prescribed a limit to the extension of the contract conditioned on a future event, specifically, the receipt by K Services of notice of termination from MIAA. In effect, the phrase provided a resolutory facultative condition. It should be noted that 'until' is a 'word of limitation, used ordinarily to restrict that which precedes to what immediately follows it, and its office is to fix some point of time or some event upon the arrival or occurrence of which what precedes will cease to exist.'" *(Manila International Airport Authority vs. Court of Appeals, 397 SCRA 348 [2003].)*

### Casual condition.

(1) If the suspensive condition depends upon chance or upon the will of a third person, the obligation subject to it is valid.

EXAMPLES:

(1) Where X, building contractor, obliges himself in favor of Y owner, to repair at X's expense any damage that may be caused to the building by any earthquake occurring within ten (10) years from the date of the completion of its construction.

(2) Where S binds himself to sell his land to S if he wins a case which is pending before the Supreme Court.

(2) When the fulfillment of the condition does not depend on the will of the obligor, but that on a third person who can in no way be compelled to carry it out, and it is found by the court that the obligor has done all in his power to comply with his obligation, his part of the contract is deemed complied with and he has a right to demand performance of the contract by the other party. (see Smith Bell & Co. vs. Sotelo Matti, 44 Phil. 875 [1923], under Art. 1193.)

**Mixed condition.**

The obligation is valid if the suspensive condition depends partly upon chance and partly upon the will of a third person.

EXAMPLE:

Where X, building contractor, obliges himself in favor of Y, owner, to repair at X's expense, any damage to the building taking place after an earthquake if found by a panel of arbitrators that construction defects contributed in any way to the damage.

Both conditions must take place in order that X's obligation will arise.

ILLUSTRATIVE CASES:

1. *Validity of stipulation that debtor shall pay credit advances made to him as soon as he receives funds from the sale of his property.*

*Facts:* D promised to pay C certain credit advances made to him by C "as soon as he receives funds derived from the sale of his property in Spain."

The will to sell on the part of the debtor (intestate) was present in fact, or presumed legally to exist, although the price and other conditions thereof were still within his discretion and final approval. But in addition to the acceptability of the sale to him (obligor), there were still other conditions that had to concur to effect the sales, mainly that of the presence of a buyer, ready, able, and willing to purchase the property under the conditions demanded by the vendor. Without such a buyer the sale could not be carried out or the proceeds thereof sent to the Philippines.

The Court of Appeals held that payment of the advances did not become due until the administratix received the purchase price from the buyer of the property.

*Issue:* Is the obligation subject to a condition exclusively dependent upon the will of D?

*Held:* No. (1) *Condition defendant upon other circumstances.* — The condition also depends upon other circumstances beyond the control or power of D. If the condition were "if he decides to sell his house," or "if he likes to pay the sums advanced," or any other condition of similar import implying that upon him (debtor) alone payment would depend, the condition would be *potestative,* dependent exclusively upon his will or discretion.

The condition, as stated above, implies that the obligor had already decided to sell his house, or at least that he had made his creditors believe that he had done so, and all that was needed to make the obligation demandable is that the sale be consummated and the price thereof remitted to the Philippines.

(2) *Condition, a mixed one.* — The condition of the obligation was not a purely potestative one, depending exclusively upon the will of the obligor, but a mixed one depending partly upon the will of the obligor and partly upon chance, *i.e.,* the presence of a buyer of the property for the price and under the conditions desired by the obligor. *(Hermosa vs. Longara, 93 Phil. 977 [1953].)*

*Paras, C.J., dissenting:* "It is very obvious that the matter of the sale of the house was vested on the sole will of the obligor, unaffected by any outside consideration or influence. The majority admit that if the condition were 'if he decides to sell his house, or if he likes to pay the sums advanced,' the same would be potestative. I think a mere play of words is invoked as I cannot see any substantial difference. In the case at bar, the terms are still subject to the sole judgment — if not whims and caprices of D. In fact, no sale was effected during his lifetime."

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2. *Under the contract of lease of electric light posts, the term thereof shall be as long as the lessee has need for the posts but the termination of the lease is subject also to chance or the will of a third person.*

*Facts:* Petitioner N, a telephone company, and private respondent C, a private corporation, entered into a contract for the use by the former in the operation of its telephone service the electric light posts of the latter, in consideration to the installation, free of charge, of ten (10) telephone connections for the use of C in specified places.

The contract provides, *inter alia:*

> "(a) That the term or period of this contract shall be as long as the party of the first part [N] has need for the electric light posts of the party of the second part [C] it being understood that this contract shall terminate when for any reason whatsoever, the party

of the second part is forced to stop, abandoned [sic] its operation as a public service and it becomes necessary to remove the electric light post [sic];"

Apart from applying Article 1267, the Court of Appeals held the contract was subject to a potestative condition which rendered the conditional obligation void.

Regarding this issue, N alleges that there is nothing purely potestative about the prestations of either party because N's permission for free use of telephones is not made to depend purely on its will, neither is C's permission for free use of its posts dependent purely on its will.

*Held: Contract subject to mixed conditions.* — "N's allegations must be upheld in this regard. A potestative condition is a condition, the fulfillment of which depends upon the sole will of the debtor, in which case, the conditional obligation is void. Based on this definition, respondent court's finding that the provision in the contract, to wit:

'(a) That the term or period of this contract shall be as long as the party of the first part (petitioner) has need for the electric light posts of the party of the second part (private respondent) x x x,' is a potestative condition, is correct. However, it must have overlooked the other conditions in the same provision, to wit:

"x x x it being understood that this contract shall terminate when for any reason whatsoever, the party of the second part (private respondent) is forced to stop, abandoned (sic) its operation as a public service and it becomes necessary to remove the electric light post (sic); which are casual conditions since they depend on chance, hazard, or the will of a third person.

In sum, the contract is subject to mixed conditions, that is, they depend partly on the will of the debtor and partly on chance, hazard or the will of a third person, which do not invalidate the aforementioned provision." *(Naga Telephone Co., Inc. vs. Court of Appeals, 230 SCRA 351 [1994].)*

### Where suspensive condition depends partly upon the will of debtor.

According to Manresa, the use of the word "exclusive" (now "sole") makes it clear that conditional obligations whose fulfillment depends partly upon the will of the debtor and partly upon the will of a third person, or upon chance are perfectly valid. (Jacinto vs. Chua Leng, [C.A.] 45 O.G. 2919, citing 4 Manresa 126.)

It is believed, however, that if the compliance with the obligation still depends upon that part of the condition whose fulfillment depends upon the will of the debtor, the obligation is void as it is within his power to comply or not to comply with the same. The situation is the same as if the condition depends entirely upon the will of the debtor.

**ART. 1183. Impossible conditions, those contrary to good customs or public policy and those prohibited by law shall annul the obligation which depends upon them. If the obligation is divisible, that part thereof which is not affected by the impossible or unlawful condition shall be valid.**

**The condition not to do an impossible thing shall be considered as not having been agreed upon. (1116a)**

### When Article 1183 applies.

Article 1183 refers to suspensive conditions. It applies only to cases where the impossibility already existed at the time the obligation was constituted. If the impossibility arises after the creation of the obligation, Article 1266 governs.

### Two kinds of impossible conditions.

They are:

(1) *Physically impossible conditions.* — when they, in the nature of things, cannot exist or cannot be done; and

(2) *Legally impossible conditions.* — when they are contrary to law, morals, good customs, public order, or public policy.

### Effect of impossible conditions.

(1) *Conditional obligation void.* — Impossible conditions annul the obligation which depends upon them.[4] Both the obligation and the condition are void. The reason behind the law is that the obligor knows his obligation cannot be fulfilled. He has no intention to comply with his obligation.

[4]Art. 873. Impossible conditions and those contrary to law or good customs shall be considered as not imposed and shall in no manner prejudice the heir, even if the testator should otherwise provide.

Art. 727. Illegal or impossible conditions in simple and remuneratory donations shall be considered as not imposed.

In conditional testamentary dispositions and in simple and remuneratory donations, the rule is different.

(2) *Conditional obligation valid.* — If the condition is negative, that is, not to do an impossible thing, it is disregarded and the obligation is rendered pure and valid. (par. 2.) Actually, the condition is always fulfilled when it is not to do an impossible thing so that it is the same as if there were no condition. The negative condition may be not to give an impossible thing.

(3) *Only the affected obligation void.* — If the obligation is divisible, the part thereof not affected by the impossible condition shall be valid.

EXAMPLE:

"I will give you P10,000.00 if you sell my land, and a car, if you kill Pedro."

The obligation to give P10,000.00 is valid but the obligation to give a car is void because it is dependent upon an impossible condition.

(4) *Only the condition void.* — If the obligation is a pre-existing obligation, and, therefore, does not depend upon the fulfillment of the condition which is impossible, for its existence, only the condition is void.

EXAMPLE:

D incurred an obligation in the amount of P10,000.00 in favor of C. If C later agreed to kill X before D pays him, the condition "to kill X" is void but not the pre-existing obligation of D "to pay C."

**ART. 1184. The condition that some event happen at a determinate time shall extinguish the obligation as soon as the time expires or if it has become indubitable that the event will not take place. (1117)**

## Positive condition.

The above article refers to a positive (suspensive) condition — the happening of an event at a determinate time. The obligation is extinguished:

(1) as soon as the time expires without the event taking place; or

(2) as soon as it has become indubitable that the event will not take place although the time specified has not yet expired.

EXAMPLE:

X obliges himself to give Y P10,000.00 if Y will marry W before Y reaches the age of 23.

(a) X is liable if Y marries W before he reaches the age of 23.

(b) X is not liable if Y marries W at the age of 23 or after he reaches the age of 23. In this case, the time specified, before reaching the age of 23, has expired without the condition (marrying W) being fulfilled. The obligation is extinguished *as soon as* Y becomes 23 years old.

(c) If Y dies at the age of 22 without having married W, the obligation is extinguished because it has become indubitable that the condition will not take place. In this case, the obligation of X is deemed extinguished from the death of Y, although the time specified (before reaching the age of 23) has not yet *expired*.

**ART. 1185. The condition that some event will not happen at a determinate time shall render the obligation effective from the moment the time indicated has elapsed, or if it has become evident that the event cannot occur.**

**If no time has been fixed, the condition shall be deemed fulfilled at such time as may have probably been contemplated, bearing in mind the nature of the obligation. (1118)**

### Negative condition.

The above provision speaks of a negative condition that an event will not happen at a determinate time. (see Art. 879.) The obligation shall become effective and binding:

(1) from the moment the time indicated has elapsed without the event taking place; or

(2) from the moment it has become evident that the event can not occur, although the time indicated has not yet elapsed.

If no time is fixed, the circumstances shall be considered to determine the intention of the parties. This rule may also be applied to a positive condition.

EXAMPLE:

X binds himself to give Y P10,000.00 if Y is not yet married to W on December 30.

(a) X is not liable to Y if Y marries W on December 30 or prior thereto.

(b) X is liable to Y if on December 30 Y is not married to W or if Y marries W after December 30. In the latter case, the condition (not marrying W) is fulfilled upon the expiration of the time indicated, which is December 30.

(c) Suppose W dies on November 20 without having been married to Y. The obligation is rendered effective because it is certain that the condition not to marry W will be fulfilled. In this case, the obligation becomes effective from the moment of W's death on November 20 although the time indicated (December 30) has not yet elapsed.

**ART. 1186. The condition shall be deemed fulfilled when the obligor voluntarily prevents its fulfillment. (1119)**

## Constructive fulfillment of suspensive condition.

There are three (3) requisites for the application of this article:

(1) The condition is suspensive;

(2) The obligor actually prevents the fulfillment of the condition; and

(3) He acts voluntarily.

The law does not require that the obligor acts with malice or fraud as long as his purpose is to prevent the fulfillment of the condition. He should not be allowed to profit from his own fault or bad faith to the prejudice of the obligee. In a reciprocal obligation like a contract of sale, both parties are mutually obligors and also obligees. (see Art. 1167.)

EXAMPLES:

(1) X agreed to give Y a 5% commission if the latter could sell the former's land at a certain price. Y found a buyer who definitely decided to buy the property upon the terms prescribed by X. To evade the payment of the commission agreed upon, X himself sold to the buyer the property at a lower price without the aid of Y.

In this case, it can be said that the due performance by Y of his undertaking, the condition for the payment of the commission, was purposely prevented by X, and is deemed fulfilled.

(2) S promised to sell his land to Y if Y would be able to secure a loan from a certain bank. Later on, S changed his mind about selling his land. He induced the bank not to give Y a loan.

Under the above article, the condition is deemed complied with and S is liable to sell his land. S should not be allowed to profit by his own fault or bad faith.

(3) Suppose the inducement made by S was promoted by some other reason, is there constructive fulfillment? Yes. The law does not require that S act with malice or fraud as long as his purpose is to prevent the fulfillment of the condition. But Article 1186 does not apply if the act of the obligor is in the exercise of a right.

(4) X agreed to paint the house of Y for P50,000 after completion. Before X could complete the job, Y hired Z, another contractor, who finished the painting. The condition — painting of the house — is deemed fulfilled under Article 1186 and Y's obligation to pay X P50,000 is converted to a pure obligation. (see Ong vs. Bogñalbal, 501 SCRA 490 [2006].)

ILLUSTRATIVE CASES:

1. *Agreement was entered into to defeat claim for contingent attorney's fees.*

*Facts:* The contract of services provides that the contingent fees of L (lawyer) shall be 2% of the share of (Mrs.) W in the conjugal partnership between her and her husband, H. This contract was made principally, in contemplation of a suit for divorce that W intended to file and of the liquidation of the conjugal partnership.

With the purpose of defeating L's claim for attorney's fees, W and H entered into an agreement.

*Issue:* Should the condition for the payment of attorneys' fees be deemed fulfilled?

*Held:* Yes. Bearing in mind the nature of, and the circumstances under which the contract of services were entered into, the occurrence of the event upon which the amount of said services depended was rendered impossible by W. Had she filed said action for divorce and secured a decree, said conjugal partnership would have been dissolved and then liquidated, and the share of W would have been fixed, and then the

attorney's fees due L would have been determined. The condition was deemed fulfilled. *(Recto vs. Harden, 100 Phil. 427 [1956].)*

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2. *Conditions to be entitled to a life pension cannot be fulfilled because of the abolition by company of pension plan.*

*Facts:* Before the war, PLDT established a pension plan for its employees by virtue of which an employee shall be entitled to a life pension under certain conditions (*i.e.*, age 50 and 20 years of service). After the liberation, because of war losses, the Board of Directors of PLDT abolished the pension plan. Beneficiaries to the pension plan brought action against PLDT claiming monetary benefits due them under the plan.

*Issue:* Should the conditions imposed in the pension plan be deemed fulfilled?

*Held:* Yes. PLDT may not disregard the plan at will on the ground that until the conditions are met, it has no duties whatever toward the employees. The pension was not a mere offer of gratuity by the company, inspired by no other purpose than to benefit its employees.

In reality, the plan sought to induce the employees to continue indefinitely in the service and to spur them to greater efforts in its service and increased zeal in its behalf. The plan ripened into a binding contract upon its implied acceptance by its employees. Not being a donation, there is no statutory requirement that acceptance of the plan should be express. The assent or acceptance of the employees is inferable from their entering the employ of the company, on their stay therein after the plan was made known.

Similarly, the excuse that its war losses extinguished the company's obligation to proceed with the pension plan is not meritorious. Its obligation was a generic one (to pay money) and such obligations are not extinguished by loss or inability to raise funds. (see Art. 1263.) *(Phil. Long Distance Co. vs. Jeturian, 97 Phil. 981 [1955].)*

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3. *Obligation of lessor to give notice was not fulfilled because it was made known to him after the period within which to notify expired.*

*Facts:* The surety bond requires the lessor (creditor) to report to the surety any violation of the lease contract by the lessee (debtor) within five (5) days, otherwise the bond will be null and void. The lessee defaulted on November 5. The five-day period to notify expired, therefore, on November 10.

However, the lessor received a copy of the bond from the surety only on November 21 when the lessor learned of the existence of the condition.

*Issue:* Is the surety absolved of its liability to the lessor?

*Held:* No. By not notifying the lessor earlier, the surety must be deemed to have waived the condition as to rentals already due, since a condition is deemed fulfilled when the obligor voluntarily prevents its fulfillment. *(Pastoral vs. Mutual Security Insurance Corp., 14 SCRA 1011 [1965].)*

### Constructive fulfillment of resolutory condition.

Article 1186 applies also to an obligation subject to a resolutory condition with respect to the debtor who is bound to return what he has received upon the fulfillment of the condition.

EXAMPLE:

X obliges himself to allow Y to occupy the former's house in Manila as long as X is assigned by their company in the province. When Y learned that X would be transferred to Manila, he was able to induce the president of the company to assign another person in place of X.

The obligation of X is extinguished because the fulfillment of the resolutory condition was voluntarily prevented by Y. Hence, Y must vacate the house. (see Art. 1190.)

**ART. 1187. The effects of a conditional obligation to give, once the condition has been fulfilled, shall retroact to the day of the constitution of the obligation. Nevertheless, when the obligation imposes reciprocal prestations upon the parties, the fruits and interests during the pendency of the condition shall be deemed to have been mutually compensated. If the obligation is unilateral, the debtor shall appropriate the fruits and interests received, unless from the nature and circumstances of the obligation it should be inferred that the intention of the person constituting the same was different.**

**In obligations to do and not to do, the courts shall determine, in each case, the retroactive effect of the condition that has been complied with. (1120)**

**Retroactive effects of fulfillment of suspensive condition.**

(1) *In obligations to give.* — An obligation to give subject to a suspensive condition becomes demandable only upon the fulfillment of the condition. However, once the condition is fulfilled, its effects shall retroact to the day when the obligation was constituted. (par. 1; see Enriquez vs. Ramos, 73 SCRA 116 [1976].)

The reason is because the condition is only an accidental element of a contract. (see Art. 1318.) An obligation can exist without being subject to a condition. Had the parties known beforehand that the condition would be fulfilled, they would have bound themselves under a pure obligation. Hence, the obligation should be considered from the time it is constituted and not from the time the condition is fulfilled.

It would seem that the rule on retroactivity has no application to real contracts as they are perfected only by delivery of the object of the obligation. (see Art. 1316.)

EXAMPLE:

On January 20, S agreed to sell his parcel of land to B for P100,000.00 should B lose a case involving the recovery of another parcel of land. On April 10, S sold his land to C. B lost the case on December 4.

Before December 4, B had no right to demand the sale of the land by S. When the condition, however, was fulfilled on December 4, it is as if B was entitled to the land beginning January 20. Hence, as between B and C, B will have a better right over the land. (It is required, however, under the Property Registration Decree [Pres. Decree No. 1529, Sec. 51.], that the promise of S be annotated on the back of the certificate of title of the property to be binding against third persons like C.)

If the land was sold by B to D on May 15, D would still have a better right as against C since the sale by B will be considered valid.

(2) *In obligations to do or not to do.* — With respect to the retroactive effect of the fulfillment of a suspensive condition in obligations to do or not to do, no fixed rule is provided. This does not mean, however, that in these obligations the principle of retroactivity is not applicable. The courts are empowered by the use of sound discretion and bearing in mind the intent of the parties, to determine, in each case, the retroactive effect of the suspensive condition that has been complied with. (par. 2.) It includes the power to decide that the fulfillment of

the condition shall have no retroactive effect or from what date such retroactive effect shall be reckoned.

EXAMPLES:

(1) C obliged himself to condone the debt of D, his lawyer, should the latter win C's case in the Supreme Court.

In this case, upon the fulfillment of the condition, C shall not be entitled, unless the contrary has been stipulated, to the earned interests of the capital during the pendency of the condition as the intention of C is to extinguish the debt. Here, the fulfillment of the condition has a retroactive effect.

(2) Suppose, in the preceding example, the obligation contracted by C was to construct *gratis* the house of D upon the fulfillment of the condition.

In this case, unless the contrary clearly appears, there is no retroactive effect if the condition is fulfilled, taking into consideration the nature of the obligation and the intent of the parties. Therefore, C is not liable to pay interest on the money value of the obligation for the intervening period.

**Retroactive effects as to fruits and interests in obligations to give.**

(1) *In reciprocal obligations.* — There is no retroactivity because the fruits and interests received during the pendency of the condition are deemed to have been mutually compensated. This rule is necessary for purposes of convenience since the parties would not have to render mutual accounting of what they have received. Fruits here may be natural, industrial, or civil fruits. (see Art. 442.)

EXAMPLE:

In the first example under the preceding topic, when B lost the case in court on December 4, S must deliver the land and B must pay P50,000.00.

S does not have to give the fruits received from the land before December 4 and B is not obliged to pay legal interests on the price since the fruits and interests received are deemed to have been mutually compensated.

(2) *In unilateral obligations.* — There is usually no retroactive effect because they are gratuitous. The debtor receives nothing from the

creditor. Thus, fruits and interests belong to the debtor unless from the nature and other circumstances it should be inferred that the intention of the person constituting the same was different.

EXAMPLE:

Suppose, in the same example, the promise of S was to donate the parcel of land to B.

Upon the fulfillment of the condition, S has to deliver the land but he has the right to keep to himself all the fruits and interests he may have received during the pendency of the condition, that is, from January 20 to December 4, unless a contrary intention by S may be inferred, as when it is stipulated that once the condition is fulfilled, S shall render an accounting of fruits received during its pendency.

**ART. 1188. The creditor may, before the fulfillment of the condition, bring the appropriate actions for the preservation of his right.**

**The debtor may recover what during the same time he has paid by mistake in case of a suspensive condition. (1121a)**

## Rights pending fulfillment of suspensive condition.

(1) *Rights of creditor.* — He may *take* or bring appropriate actions for the preservation of his right, as the debtor may render nugatory the obligation upon the happening of the condition. Thus, he may go to court to prevent the alienation or concealment of the property of the debtor or to have his right annotated in the registry of property. The rule in paragraph one applies by analogy to obligations subject to a resolutory condition. (see Art. 1190, par. 1.)

(2) *Rights of debtor.* — He is entitled to recover what he has paid by mistake prior to the happening of the suspensive condition. This right is granted to the debtor because the creditor may or may not be able to fulfill the condition imposed and hence, it is not certain that the obligation will arise. This is a case of *solutio indebiti* which is based on the principle that no one shall enrich himself at the expense of another.[5]

[5]Art. 2159. Whoever in bad faith accepts an undue payment, shall pay legal interest if a sum of money is involved, or shall be liable for fruits received or which should have been received if the thing produces fruits.

Note that the payment before the fulfillment of the condition must be "by mistake;" otherwise, the debtor is deemed to have impliedly waived the condition. In any case, he cannot recover what he has prematurely paid once the suspensive condition is fulfilled. But if the condition was not fulfilled, the debtor should be allowed to recover any payment made even if the debtor has paid not by mistake.

ILLUSTRATIVE CASE:

*Under a contract to sell a parcel of land, full payment was not made by the vendee because of the non-fulfillment of a suspensive condition, which property was later sold absolutely by the vendor to another.*

*Facts:* S and B entered into a contract to sell a parcel of land evidenced by a memorandum of agreement which stipulates, *inter alia*, that S, vendor, reserves to herself ownership and possession of the property until full payment of the purchase price by B and that the balance thereof was payable within six (6) months from the date S would notify B that the certificate of title of the property could be transferred to B. Subsequently, S executed a deed of absolute sale of the property in favor of T.

It appeared that S exerted efforts to register the property, and B had no intention to buy the property and was only interested in dealing with other buyers to make a profit. S even pleaded with him several times to purchase the property, less the expenses of registration, as there were other interested buyers.

*Issue:* Is B entitled to recover the property in question from T?

*Held:* No. There was no actual sale. On the part of B, no full payment would be made until a certificate of title of the property was ready for transfer in his name.

Under the second paragraph of Article 1188, even if B did not mistakenly make partial payments, inasmuch as the suspensive condition was not fulfilled it is only fair and just that B be allowed to recover what he had paid S in expectancy that the condition would be fulfilled; otherwise, there would be unjust enrichment on the part of S. In this case, the heirs of S were ordered to also pay B interest at 12% *per annum* on the sum received by S from the time the Regional Trial Court rendered its original decision. *(Buot vs. Court of Appeals, 357 SCRA 846 [2001].)*

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Art. 2160. He who in good faith accepts an undue payment of a thing certain and determinate shall only be responsible for the impairment or loss of the same or its accessories and accessions insofar as he has thereby been benefited. If he has alienated it, he shall return the price or assign the action to collect the sum. (1897)

**ART. 1189. When the conditions have been imposed with the intention of suspending the efficacy of an obligation to give, the following rules shall be observed in case of the improvement, loss or deterioration of the thing during the pendency of the condition:**

**(1) If the thing is lost without the fault of the debtor, the obligation shall be extinguished;**

**(2) If the thing is lost through the fault of the debtor, he shall be obliged to pay damages; it is understood that the thing is lost when it perishes, or goes out of commerce, or disappears in such a way that its existence is unknown or it cannot be recovered;**

**(3) When the thing deteriorates without the fault of the debtor, the impairment is to be borne by the creditor;**

**(4) If it deteriorates through the fault of the debtor, the creditor may choose between the rescission of the obligation and its fulfillment, with indemnity for damages in either case;**

**(5) If the thing is improved by its nature, or by time, the improvement shall inure to the benefit of the creditor;**

**(6) If it is improved at the expense of the debtor, he shall have no other right than that granted to the usufructuary. (1122)**

### Requisites for application of Article 1189.

Article 1189 applies only if:

(1) The obligation is a real obligation;

(2) The object is a specific or determinate thing;

(3) The obligation is subject to a suspensive condition;

(4) The condition is fulfilled; and

(5) There is loss, deterioration, or improvement of the thing during the pendency of the happening on one condition.

### Kinds of loss.

Loss in civil law may be:

(1) *Physical loss.* — when a thing perishes as when a house is burned and reduced to ashes; or

(2) *Legal loss.* — when a thing goes out of commerce (*e.g.,* when it is expropriated) or when a thing heretofore legal becomes illegal

(*e.g.*, during the Japanese occupation, American dollars had become impossible since their use was forbidden by the belligerent occupant); or

(3) *Civil loss.* — when a thing disappears in such a way that its existence is unknown (*e.g.*, a particular dog has been missing for sometime); or even if known, it cannot be recovered (Art. 1189[2].), whether as a matter of fact (*e.g.*, a particular ring is dropped from a ship at sea) or of law (*e.g.*, a property is lost through prescription). (see Art. 1262.)

**Rules in case of loss, etc. of thing during pendency of suspensive condition.**

(1) *Loss of thing without debtor's fault.* —

EXAMPLE:

D obliged himself to give C his car worth P100,000.00 if C sells D's property. The car was lost without the fault of D.

The obligation is extinguished and D is not liable to C even if C sells the property. A person, as a general rule, is not liable for a fortuitous event. (Art. 1174.)

(2) *Loss of thing through debtor's fault.* —

EXAMPLE:

In the same example, if the loss occurred because of the negligence of D, C will be entitled to demand damages (Art. 1170.), *i.e.*, P100,000.00 plus incidental damages, if any.

(3) *Deterioration of thing without debtor's fault.* — A thing deteriorates when its value is reduced or impaired with or without the fault of the debtor.

EXAMPLE:

If the car figured in an accident, as a result of which its windshield was broken and some of its paints were scratched away without the fault of D, thereby reducing its value to P80,000.00, C will have to suffer the deterioration of impairment in the amount of P20,000.00. (Art. 1174.)

(4) *Deterioration of thing through debtor's fault. —*

EXAMPLE:

In this case, C may choose between:

(a) Rescission (or cancellation) of the obligation with damages; in the case D is liable to pay P100,000.00, value of the car before its deterioration plus incidental damages, if any; or

(b) Fulfillment of the obligation also with damages (see Art. 1191.); in this case, D is bound to C to give the car and pay P20,000.00 plus incidental damages, if any.

(5) *Improvement of thing by nature or by time. —* A thing is improved when its value is increased or enhanced by nature or by time or at the expense of the debtor or creditor. (see Art. 1187.)

EXAMPLE:

Suppose the market value of the car increased, who gets the benefit?

The improvement shall inure to the benefit of C. Inasmuch as C would suffer in case of deterioration of the car through a fortuitous event, it is but fair that he should be compensated in case of improvement of the car instead.

(6) *Improvement of thing at expense of debtor. —*

EXAMPLE:

During the pendency of the condition, D had the car painted and its seat cover changed at his expense.

In this case, D will have the right granted to a usufructuary with respect to improvements made on the thing held in usufruct.[6]

[6]Art. 562. Usufruct gives a right to enjoy the property of another with the obligation of preserving its form and substance, unless the title constituting it or the law otherwise provides. (467)

Art. 579. The usufructuary may make on the property held in usufruct such useful improvements or expenses for mere pleasure as he may deem proper, provided he does not alter its form or substance; but he shall have no right to be indemnified therefor. He may, however, remove such improvements, should it be possible to do so without damage to the property. (487)

Art. 580. The usufructuary may set off the improvements he may have made on the property against any damage to the same. (488)

**ART. 1190. When the conditions have for their purpose the extinguishment of an obligation to give, the parties upon the fulfillment of said conditions, shall return to each other what they have received.**

**In case of the loss, deterioration or improvement of the thing, the provisions which, with respect to the debtor, are laid down in the preceding article shall be applied to the party who is bound to return.**

**As for obligations to do and not to do, the provisions of the second paragraph of Article 1187 shall be observed as regards the effect of the extinguishment of the obligation. (1123)**

### Effects of fulfillment of resolutory condition.

(1) *In obligations to give.* — When the resolutory condition in an obligation to give is fulfilled, the obligation is extinguished (Art. 1181.) and the parties are obliged to return to each other what they have received under the obligation. (par. 2.)

(a) There is a return to the *status quo.* In other words, the effect of the fulfillment of the condition is retroactive.

(b) The obligation of mutual restitution is absolute. It applies not only to the things received but also to the fruits and interests.

(c) In case the thing to be returned "is legally in the possession of a third person who did not act in bad faith" (see Art. 1384, par. 2.), the remedy of the party entitled to restitution is against the other.

(d) In obligations to give subject to a suspensive condition, the retroactivity admits of exceptions according to whether the obligation is bilateral or unilateral. (see Art. 1187.) Here, there are no exceptions, whether the obligation is bilateral or unilateral.

The reason for the difference is quite plain. The happening of the suspensive condition gives birth to the obligation. On the other hand, the fulfillment of the resolutory condition produces the extinguishment of the obligation as though it had never existed. (see 8 Manresa 149-150.) The only possible exception is when the intention of the parties is otherwise.

(e) If the condition is not fulfilled, the rights acquired by a party become vested.

EXAMPLE:

D obliges himself to allow C to use the former's car until D returns from the province. Upon the return of D from the province, C must give back the car.

The effect of the happening of the condition is to annul the obligation as if it had never been constituted at all. In this case, the parties intend the return of the car.

(2) *In obligations to do or not to do.* — In some obligations, the courts shall determine the retroactive effect of the fulfillment of the resolutory condition (par. 2.) as in the case where the condition is suspensive. (Art. 1187, par. 2.) The courts in the exercise of discretion may even disallow retroactivity taking into account the circumstances of each case.

**Applicability of Article 1189 to party with obligation to return.**

In the example above, D is the debtor and C, the creditor, pending fulfillment of the resolutory condition — the return of D from the province. Upon the happening of the condition. D becomes the creditor with a right to demand the return of the car and C, the debtor, with the obligation to return the car.

Stated in another way, the happening of a resolutory condition has the same effect on the creditor as the suspensive condition has, on the debtor — an obligation arises. The fulfillment of the resolutory condition converts the creditor into debtor, and the debtor into creditor. Hence, the applicability of the provisions of Article 1189 in case of loss, deterioration, or improvement of the thing; and pending the fulfillment of the condition, the parties are entitled to the rights granted by Article 1188.

**ART. 1191. The power to rescind obligations is implied in reciprocal ones, in case one of the obligors should not comply with what is incumbent upon him.**

**The injured party may choose between the fulfillment and the rescission[7] of the obligation, with the payment of damages**

[7]This remedy in case of breach of obligation should not be confused with rescission in Article 1281, *et seq.* Under the former provision, a distinction existed between rescission and resolution. (see Note under Art. 1381.)

**in either case. He may also seek rescission, even after he has chosen fulfillment, if the latter should become impossible.**

**The court shall decree the rescission claimed, unless there be just cause authorizing the fixing of a period.**

**This is understood to be without prejudice to the rights of third persons who have acquired the thing, in accordance with Articles 1385 and 1388 and the Mortgage Law.[8] (1124)**

## Kinds of obligation according to the person obliged.

They are:

(1) *Unilateral.* — when only one party is obliged to comply with a prestation.

EXAMPLES:

Donation; In a contract of loan, the lender has the obligation to give. After the lender has complied with his obligation, the debtor has the obligation to pay.

(2) *Bilateral.* — when both parties are mutually bound to each other. In other words, both parties are debtors and creditors of each other. Bilateral obligations may be reciprocal or non-reciprocal.

(a) *Reciprocal obligations* are those which arise from the same cause and in which each party is a debtor and creditor of the other, such that the performance of one is designed to be the equivalent and the condition for the performance of the other. The general rule is that they are to be performed simultaneously or at the same time such that each party may treat the fulfillment of what is incumbent upon the other as a suspensive condition to his obligation (see Art. 1169, last par.), and its non-fulfillment, as a tacit or implied resolutory condition, giving him the right to demand the rescission of the contract, *i.e.*, it may be exercised even if it is not provided in the agreement of the parties.

[8]Pres. Decree No. 892 has discontinued the system of registration under the Spanish Mortgage Law and of the use of Spanish titles in land registration proceedings. This discontinuance was reiterated in Pres. Decree No. 1529, the Property Registration Decree, which superseded Act No. 496, as amended, the Land Registration Act.

EXAMPLE:

In a contract of sale in the absence of any stipulation, the delivery of the thing sold by the seller is conditioned upon the simultaneous payment of the purchase price by the buyer, and *vice versa.* (see Art. 1169, last par.)

The seller is the creditor as to the price and debtor as to the thing, while the buyer is the creditor as to the thing and debtor as to the price.

(b) *Non-reciprocal obligations* are those which do not impose simultaneous and correlative performance on both parties. In other words, the performance of one party is not dependent upon the simultaneous performance by the other.

EXAMPLES:

(1) D borrowed from C P50,000.00. C, on the other hand, borrowed D's car. The performance by D of his obligation to C is not conditioned upon the performance by C of his obligation and *vice versa.*

Although D and C are debtors and creditors of each other, their obligations are not reciprocal. The obligation of D arises from the contract of loan, while that of C, from the contract of commodatum. The obligations are not dependent upon each other and are not simultaneous. Article 1191 applies only if the reciprocity arises from the same cause.

(2) The contract between S and B states: "In the event S exercises the right to repurchase [land sold by S to B] x x x and becomes the owner of the premises, he shall be obliged to give B the right of lease and execute a lease contract."

Here, no reciprocal obligation is created between them for B to reconvey the premises and for S to lease them to B. There are two separate and distinct obligations, each independent of the other. The obligation of B to reconvey is not dependent on the obligation of S to lease. The obligation of S is not an essential part of the contract.

In other words, the obligation of S to lease the property to B arises only after B had reconveyed the same to S. (see Sangcuan vs. Intermediate Appellate Court, 191 SCRA 28 [1990].)

**Remedies in reciprocal obligations.**

Article 1191 is the general provision on rescission of reciprocal obligations. It speaks of the right of the "injured party" to choose between rescission or fulfillment of the obligation, with the right to claim damages in either case. It governs where there is non-compliance by one of the contracting parties in case of reciprocal obligations.

The remedy granted is predicated on a *breach* of obligation by the other party that violates the reciprocity between them. The breach contemplated is the obligor's failure to comply with an *existing* obligation, not a failure of a condition to render binding that obligation. (see Ong vs. Court of Appeals, 310 SCRA 1 [1999]; Information Technology Foundation vs. Commission on Elections, 419 SCRA 626 [2004].) It would, of course, be useless to rescind a contract that is no longer in existence. (Yaneza vs. Court of Appeals, 572 SCRA 413 [2008].)

**Choice of remedy by injured party.**

In case one of the obligors does not comply with what is incumbent upon him, the injured or aggrieved party may choose between two remedies:

(1) action for specific performance (fulfillment) of the obligation with damages;[9] or

(2) action for rescission[10] of the obligation also with damages. (see Soorajimul Nagarmull vs. Binalbagan Isabela Sugar Company, Inc., 33 SCRA 46 [1970].)

Rescission applicable to reciprocal obligations is to be distinguished from rescission for lesion contemplated in Article 1380, *et seq.* and from cancellation of a contract based, for example, on defect in the consent (see Arts. 1318, 1330.), and not on the breach by a party of his obligation. When a party asks for the rescission of a contract, he impliedly recognizes its existence.

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[9]Under a *contract to sell,* the non-payment of the purchase price renders the contract ineffective and without force and effect. It is not a *breach* of contract but merely an *event* that prevents the seller from conveying title to the purchaser. Article 1191 presupposes an obligation already extant. Thus, a cause of action for specific performance does not arise.

[10]To rescind is "to declare a contract void in its inception and to put an end to it as though it never were." It is "not merely to terminate it and release parties from further obligations to each other but to abrogate it from the beginning and restore parties to relative positions which they would have occupied had no contract even been made." A complaint for the cancellation of the vendee's adverse claim on the vendor's original certificate of title and for the refund of the payments made by the vendee cannot be considered as seeking the rescission of the contract of sale. In other words, seeking discharge from contractual obligations and offer for restitution by the vendor is not the same as the abrogation of the contract. (Ocampo vs. Court of Appeals, 233 SCRA 551 [1994].)

The rescission of a sale of immovable is governed by Article 1592. (see Note 15.)

EXAMPLE:

In a contract of sale of a car between S and B, it was agreed that S, the owner, would deliver the car and the necessary document duly signed by him to B at the house of C on December 1, and B would deliver the payment at the same place and on the same date.

If S does not comply with his obligation.

(a) B may, in an action for specific performance, demand the delivery of the car with damages; or

(b) B may demand from the court the rescission of the contract also with damages.

If after delivery of the car by S, it is B who fails to make good the price, such failure, in the absence of stipulation that "ownership of the thing shall not pass to the purchaser until he has fully paid the price" (Art. 1478.), does not cause the ownership to revest to S, unless the bilateral contract of sale is first rescinded pursuant to Article 1191. Non-payment only creates likewise a right to demand the fulfillment of the obligation or, in case of a substantial breach, to rescind the contract under Article 1191. (Balatbat vs. Court of Appeals, 261 SCRA 128 [1996]; Heirs of P. Escanlar vs. Court of Appeals, 281 SCRA 177 [1997]; Villaflor vs. Ocampo, 280 SCRA 297 [1997]; Molina vs. Court of Appeals, 398 SCRA 97 [2003].)

When a party demands rescission in reciprocal obligations he, in effect, treats the *non-fulfillment* by the other party of his obligation as a resolutory condition.

**Breach of obligation on part of plaintiff.**

*Breach of an obligation* occurs when there is a failure or refusal, by a party without legal reason or excuse to perform, in whole or in part the obligation or undertaking which is incumbent upon him.

Under the rule of *exceptio non adimpleti contractus*, the party who has not performed his part of the agreement is not entitled to sue. (Marin vs. Adil, 130 SCRA 406 [1984].) Where the plaintiff is the party who did not perform the undertaking which he was bound to perform by the terms of the contract, he is not entitled to insist upon its performance by the defendant, or recover damages by reason of his own breach. (Seva vs. Berwin, 48 Phil. 581 [1926].)

Only the injured party can rescind a contract without violating the principle of mutuality of contracts (see Art. 1308.), which prohibits

allowing the validity and performance of contracts to be left to the will of one of the parties. (Lim vs. Court of Appeals, 263 SCRA 569 [1996].) The party who did not perform his part of the agreement has no right to insist upon the performance of the other party. The right to rescind may be exercised even in the absence of any stipulation giving the right should the other obligor fail to comply with his obligation, it being unjust that be held bound to fulfill his undertakings when the other violates his.

**Existence of economic prejudice not required.**

The principal action for rescission for non-performance under Article 1191 must be distinguished from the subsidiary action for rescission by reason of *lesion* or damage under Article 1381, *et seq.* The effect of rescission is also provided in Article 1385. Unlike, however, Article 1385, Article 1191 is not predicated on *lesion* or economic prejudice to one of the parties but on breach of faith by one of them that violates the reciprocity between them. (Deiparine, Jr. vs. Court of Appeals, 221 SCRA 503 [1993]; Francisco vs. DEAG Construction, Inc., 543 SCRA 644 [2008]; Congregation of the Religious of the Virgin Mary vs. Orola, 553 SCRA 578 [2008].) The prevailing doctrine is that a contract of sale entered into in violation of a right of first refusal of another person is rescissible. (Conculada vs. Court of Appeals, 367 SCRA 164 [2001].)

Article 1385 applies to rescission of reciprocal obligations under Article 1191. The applicability of Article 1191 is subject to other provisions of law.

**Effect of rescission.**

Generally, to rescind a contract is not merely to terminate it, but to abrogate and undo it from the beginning, that is, not merely to release the parties from further obligations to each other in respect to the subject of the contract, but to annul the contract and restore the parties to the relative positions which they would have occupied as if no such contract had ever been made. (Serrano vs. Court of Appeals, 457 SCRA 415 [2003]; Raquel-Santos vs. Court of Appeals, 592 SCRA 169 [2009].) To rescind a contract is to put an end to it, abrogating it in all its party as though it never was. (Unlad Resources Dev. Corp. vs. Dragon, 560 SCRA 63 [2008].)

In case of rescission of contract based on Article 1191, mutual restitution is required to bring back the parties, as far as practicable, to their original situation prior to the inception of the contract. Rescission creates the obligation to return the object of the contract. It requires a mutual restitution of the benefits each party may have received as a result of the contract. It can be carried out only when the one who demands rescission can return whatever he may be obliged to restore. To rescind is to declare a contract void and to abrogate it from its inception. (Velarde vs. Court of Appeals, 361 SCRA 56 [2001]; Supercars Management & Development Corporation vs. Flores, 446 SCRA 34 [2004]; Laperal vs. Solid Homes, Inc., 460 SCRA 375 [2005]; Carrascoso, Jr. vs. Court of Appeals, 477 SCRA 666 [2006]; see Art. 1385.)

ILLUSTRATIVE CASES:

1. *Applicability of Article 1191 to contract of lease.*

*Facts:* E (lessee) bound himself not to make any construction upon the property leased without the permission of R (lessor), and in case he should do so, "it shall be for the benefit of the property, without any right to ask for reimbursement for its cost."

The parties did not expressly provide for rescission in case of breach of this stipulation.

*Issue:* Has R the right to ask for the rescission of the contract of lease for violation of the clause in question?

*Held:* Yes. Obligations arising from a contract of lease being reciprocal such obligations are governed by Article 1191 which declares that in this kind of obligations the power to rescind it in case one of the obligors should not fulfill his part is implied.

R could have asked for the fulfillment of the obligation not to construct any work upon his property without his permission, and in such case, it would have been necessary to undo all that was done, destroying the construction, in order to lease the property in its original condition; but as he made use of the right of rescission granted him by law, the court must decree the resolution asked unless there be causes justifying it to fix a term. *(Cui vs. Sun Chan, 41 Phil. 523 [1921].)*

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2. *Applicability of Article 1191 to contract of partnership.*

*Facts:* X brought action for the rescission of a contract of partnership for failure of Y to contribute all the capital he had bound himself to invest.

*Issue:* Does Article 1191 apply to contracts of partnership?

*Held:* No. Owing to Y's failure to pay to the partnership the whole amount which he bound himself to contribute, he became indebted to it for the remainder (Art. 1786, par. 1.), with interest and any damages occasioned thereby (Art. 1988, par. 1.), but X did not thereby acquire the right to demand rescission of the partnership contract.

Article 1191 refers to resolution of obligations in general, whereas Articles 1786 and 1788 especially refer to the contract of partnership in particular. And it is a well-known principle that special provisions prevail over general provisions. *(Sancho vs. Lizarraga, 55 Phil. 601 [1931].)*

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3. *Applicability of Article 1191 to a deed of sale with a mortgage to secure payment of the balance of the purchase price.*

*Facts:* The above deed of sale grants to R, the vendor-mortgagee, the right to foreclose in the event of the failure of E, the vendee-mortgagor, to comply with any provision of the mortgage. There is no dispute that the parties entered into a contract of sale as distinguished from a contract to sell.

*Issue:* May R avail of the remedy of rescission under Article 1191 on reciprocal obligations?

*Held:* No. R has fully complied with his part of the reciprocal obligation as evidenced by the transfer certificate of title in E's name. E, in turn, fulfilled his end of the bargain when he executed the mortgage.

The payments on an installment basis secured by the execution of the mortgage took the place of a cash payment. In other words, the relationship between the parties is no longer one of buyer and seller because the contract of sale has been perfected and consummated. It is already one of a mortgagor and a mortgagee. In consideration of E's promise to pay on installment basis the sum he owes R, the latter accepted the mortgage as security for the obligation. E's breach of obligation is not with respect to the perfected contract of sale but in the obligations created by the mortgage contract.

The remedy of rescission is not a principal action retaliatory in character but becomes a subsidiary one which by law is available only in the absence of any other legal remedy. (see Art. 1384.) Foreclosure here is not only a remedy accorded by law but is a specific provision found in the contract between the parties. *(Suria vs. Intermediate Appellate Court, 151 SCRA 661 [1987].)*

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4. *Action for rescission of contract with payment of liquidated damages.*

*Facts:* For the exclusive right to publish a manuscript containing commentaries on the Revised Penal Code written by X, Y corporation

agreed to pay X P30,000.00 payable in eight (8) quarterly installments. The parties stipulated that should Y fail to pay any of the installments due, the rest shall be deemed due and payable whether there is judicial or extrajudicial demand.

For his part, X obligated himself to deliver the manuscript to Y not later than December 31, 1948.

X claims that Y breached the contract when it failed to pay the full amount of the installment for the first quarter. On the other hand, Y contends that X failed to deliver to it the manuscript on the date stipulated and for that reason it was no longer under obligation to pay the unpaid balance of the installments.

It appeared that on December 16, 1948, X wrote and delivered a letter advising Y that the manuscript subject of the contract was then at its disposal, ready to go to the printer should Y desire to publish it.

*Issue:* Had X performed his part of the contract?

*Held:* Yes. It has been established that such letter was written and delivered to Y. This constitutes delivery of the manuscript for delivery does not mean physical or material delivery thereof. But while the delay in the payment of the first quarterly installment may not amount to a breach of contract to justify the enforcement of the stipulation set forth in the contract because X accepted payment which completed the full amount of the installment due, it appearing that Y made no further payment on the subsequent installments due, the stipulation in the contract has to be enforced.

The action brought by X is for resolution of reciprocal obligations because one of the obligors failed to comply with that which was incumbent upon him. The injured party could choose between requiring specific performance of the obligation or its resolution with indemnity for losses and payment of interest. In the case at bar, the aforesaid stipulation in the contract may be considered as liquidated damages to be paid in case of breach of the contract. Y, being the one that breached the contract cannot claim any damage against X. *(Albert vs. University Publishing Co., Inc., 103 Phil. 351 [1958].)*

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5. *Insurance company offered to reinstate insurance policy it had previously cancelled upon a finding that the cancellation was erroneous.*

*Facts:* Seven months after the issuance of petitioner A's personal accident insurance policy, respondent insurance company unilaterally cancelled the same since company records revealed that A failed to pay his premiums. Respondent later offered to reinstate same policy it had

previously cancelled and even proposed to extend its lifetime upon a finding that the cancellation was erroneous and that the premiums were paid in full by A but were not remitted by M, respondent's branch manager who misappropriated the same.

An action for damages due to breach of contract was instituted by A against respondent.

It is petitioner-insured's submission that the fraudulent act of the manager of respondent insurance company's branch office in Baguio, in misappropriating his premium payments is the proximate cause of the cancellation of the insurance policy. A theorized that act of signing and even sending the notice of cancellation himself, notwithstanding his personal knowledge of petitioner-insured's full payment of premiums, further reinforces the allegation of bad faith. Such fraudulent act committed by M, argued A is attributable to respondent insurance company, an artificial corporate being which can act only through its officers or employees.

M's actuation, concludes petitioner-insured, is, therefore, not separate and distinct from that of respondent-insurance company, contrary to the view held by the Court of Appeals. It must, therefore, bear the consequences of the erroneous cancellation of subject insurance policy caused by the non-remittance by its own employee of the premiums paid. Subsequent reinstatement, according to A, could not possibly absolve respondent insurance company from liability, there being an obvious breach of contract. After all, reasoned out A, damage had already been inflicted on him and no amount of rectification could remedy the same.

Respondent insurance company, on the other hand, argues that where reinstatement, the equitable relief sought by A was granted at an opportune moment, *i.e.*, prior to the filing of the complaint, is left without a cause of action on which to predicate his claim for damages. Reinstatement, it further explained, effectively restored petitioner-insured to all his rights under the policy. Hence, whatever cause of action there might have been against it, no longer exists and the consequent award of damages ordered by the lower court is unsustainable.

*Issue:* There are two issues for resolution in the case. First, did the erroneous act of cancelling subject insurance policy entitled A, insured, to payment of damages? And second, did the subsequent act of reinstating the wrongfully cancelled insurance policy by respondent insurance company, in an effort to rectify such error obliterate whatever liability for damages it may have to bear, thus absolving it therefrom.

*Held:* (1) *M's fraudulent act imputable to respondent.* — "We uphold petitioner-insured's submission. Malapit's fraudulent act of misappropriat-

ing the premiums paid by petitioner-insured is beyond doubt directly imputable to respondent insurance company. A corporation, such as respondent insurance company, acts solely thru its employees. The latters' acts are considered as its own for which it can be held to account. The facts are clear as to the relationship between private respondent insurance company and Malapit.

As admitted by private respondent insurance company in its answer, Malapit was the manager of its Baguio branch. It is beyond doubt that he represented its interests and acted in its behalf. His act of receiving the premiums collected is well within the province of his authority. Thus, his receipt of said premiums is receipt by private respondent insurance company who, by provision of law, particularly under Article 1910[11] of the Civil Code, is bound by the acts of its agent."

(2) *Fact that respondent itself was defrauded not a defense.* — "Malapit's failure to remit the premiums he received cannot constitute a defense for private respondent insurance company; no exoneration from liability could result therefrom. The fact that private respondent insurance company was itself defrauded due to the anomalies that took place in its Baguio branch office, such as the non-accrual of said premiums to its account, does not free the same from its obligation to petitioner Areola. As held in *Prudential Bank vs. Court of Appeals, 223 SCRA 350 [1993], citing the ruling in McIntosh Dakota Trust Co.* (52 ND 752; 204 NW 818, 40 ALR 1021.):

'A bank is liable for wrongful acts of its officers done in the interests of the bank or in the course of dealings of the officers in their representative capacity but not for acts outside the scope of their authority. A bank holding out its officers and agent as worthy of confidence will not be permitted to profit by the frauds they may thus be enabled to perpetrate in the apparent scope of their employment; nor will it be permitted to shirk its responsibility for such frauds, even though no benefit may accrue to the bank therefrom. Accordingly, a banking corporation is liable to innocent third persons where the representation is made in the course of its business by any agent acting within the general scope of his authority even though, in the particular case, the agent is secretly abusing his authority and attempting to perpetrate a fraud upon his principal or some other person, for his own ultimate benefit.'"

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[11]Art. 1910. The principal must comply with all the obligations which the agent may have contracted within the scope of his authority.

As for any obligation wherein the agent has exceeded his power, the principal is not bound except when he ratifies it expressly or tacitly. (1727)

(3) *Insurance contract creates reciprocal obligations.* — "Consequently, respondent insurance company is liable by way of damages for the fraudulent acts committed by Malapit that gave occasion to the erroneous cancellation of subject insurance policy. Its earlier act of reinstating the insurance policy can not obliterate the injury inflicted on petitioner-insured.

Respondent company should be reminded that a contract of insurance creates reciprocal obligations for both insurer and insured. Reciprocal obligations are those which arise from the same cause and in which each party is both a debtor and a creditor of the other, such that the obligation of one is dependent upon the obligation of the other."

(4) *Respondent liable for damages.* — "Under the circumstances of the instant case, the relationship as creditor and debtor between the parties arose from a common cause, *i.e.*, by reason of their agreement to enter into a contract of insurance under whose terms, respondent insurance company promised to extend protection to petitioner-insured against the risk insured for a consideration in the form of premiums to be paid by the latter.

Under the law governing reciprocal obligations, particularly the second paragraph of Article 1191, the injured party, petitioner-insured in this case, is given a choice between fulfillment or rescission of the obligation in case one of the obligors, such as respondent insurance company, fails to comply with what is incumbent upon him. However, said article entitles the injured party to payment of damages, regardless of whether he demands fulfillment or rescission of the obligation. Untenable then is respondent insurance company's argument, namely, that reinstatement being equivalent to fulfillment of its obligation, divests petitioner-insured of a rightful claim for payment of damages. Such a claim finds no support in our laws on obligations and contracts."

(5) *The nature of damages to be awarded.* — "The nature of damages to be awarded, however, would be in the form of nominal damages contrary to that granted by the court below. Although the erroneous cancellation of the insurance policy constituted a breach of contract, private respondent insurance company, within a reasonable time took steps to rectify the wrong committed by reinstating the insurance policy of petitioner. Moreover, no actual or substantial damage or injury was inflicted on petitioner Areola at the time the insurance policy was cancelled.

Nominal damages are recoverable where a legal right is technically violated and must be vindicated against an invasion that has produced no actual present loss of any kind, or where there has been a breach of

contract and no substantial injury or actual damages whatsoever have been or can be shown.

The respondent is ordered to pay nominal damages in the amount of P30,000.00 plus legal rate of interest computed from the date of filing of complaint until final payment thereof. *(Areola vs. Court of Appeals, 236 SCRA 645 [1994].)*

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6. *Shares of stock of a corporation engaged in tourism sold without prior approval of Ministry of Tourism as required by law.*

*Facts:* S sold to B shares of stock of a corporation engaged in tourism, without prior approval of the Ministry of Tourism as required by its Rules and Regulations promulgated pursuant to Presidential Decree No. 189 creating the former Department of Tourism. The purpose of the requirement is to ensure that only those persons and entities who are fit and responsible should engage in tour operation business.

*Issue:* Is the sale void *ab initio* or merely rescissible for lack of the required approval?

*Held:* Pursuant to Article 1409(7), the sale is inexistent and null and void from the beginning. For it is well-settled that any contract entered into must be in accordance with and not repugnant to an applicable statute whose terms are deemed embodied therein and without need of the parties expressly making reference to it. *(E.Y. Yuchengco vs. Velayo, 115 SCRA 307 [1982].)*

*Aquino, J., concurring in the result:*

The sale is a rescissible contract under Articles 1191, 1547(2)[12] and 1599(4)[13] of the Civil Code because S failed to comply with his representation and warranty in the contract of sale. It was incumbent upon S to deliver to B the approval of the Ministry of Tourism of the sale and of the concomitant transfer of the tour-operator's license to B.

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[12]Art. 1547. In a contract of sale, unless a contrary intention appears, there is:

x x x x x x

(2) An implied warranty that the thing shall be free from any hidden faults or defects, or any charge or encumbrance not declared or known to the buyer.

x x x x x x

[13]Art. 1599. Where there is a breach of warranty by the seller, the buyer may, at his election:

x x x x x x

(4) Rescind the contract of sale and refuse to receive the goods or if the goods have already been received, return them or offer to return them to the seller and recover the price or any part thereof which has been paid. x x x

**Court may grant guilty party term for performance.**

The court shall decree the rescission claimed unless there should be just cause for granting the party in default a term for the performance of his obligation. (par. 3.) Obviously, this exception applies only where the guilty party is willing to comply with his obligation but needs time to do so and not where he refuses to perform.

ILLUSTRATIVE CASE:

*After paying 4 monthly installments, buyer refused any more to pay the succeeding 116 monthly installments.*

*Facts:* Under the contract to sell, B obliged himself to pay S the purchase price of the subject lots on an equal monthly installment basis for a period of 10 years or 120 equal monthly installments. After paying 4 monthly installments, B refused to pay further installments, insisting that he had the option to pay the purchase price any time in 10 years inspite of the clearness and certainty of his agreement with S.

"As a matter of justice and equity," the Court of Appeals granted B a period within which to comply with his obligation, "considering that the removal of his house [worth P45,000 erected on the land] would amount to a virtual forfeiture of the value of the house."

*Issue:* Is the benefit stated in Article 1191 (3rd par.) applicable to B?

*Held:* No. (1) *B's breach substantial and in bad faith.* — To grant B an additional period would be tantamount to excusing his bad faith and sanctioning the deliberate infringement of a contractual obligation that is repugnant and contrary to the stability, security and obligatory force of contracts. Moreover, B's failure to pay the succeeding installments (about 92% of the agreed price) is a substantial and material breach on his part, not merely casual, which takes the case out of the application of the benefits of Article 1191. (3rd par.)

(2) *Absence of just cause for grant of additional period.* — The erection by B of his house on the property does not warrant the fixing of an additional period, for to grant the same would place the vendor at the mercy of the vendee who can easily construct substantial improvements on the land beyond the capacity of the vendor to reimburse in case he elects to rescind the contract by reason of the vendee's default or deliberate refusal to pay or continue paying the purchase price of the land. Under this design, stratagem or scheme, the vendee can cleverly and easily "improve out" the vendor of his land. More than that, B has

been enjoying the possession of the land without paying the other 116 monthly installments for a period of 26 years. *(Roque vs. Lapuz, 96 SCRA 741 [1980].)*

**Remedies are alternative.**

The remedies of the injured or aggrieved party are alternative and not cumulative, that is, he is privileged to choose only one of the remedies, and not both, subject only to the exception in paragraph 2, to wit: he may also seek rescission even after he has chosen fulfillment if the latter should become impossible. But after choosing rescission of the obligation, he cannot thereafter demand its compliance, nor seek partial fulfillment under the guise of recovering damages. (Siy vs. Court of Appeals, 138 SCRA 536 [1985].)

While the right of choice remains with the plaintiff, an alternative prayer in the complaint for fulfillment or rescission is permissible in the discretion of the court for in such case it cannot be said that the plaintiff is availing of both remedies.

ILLUSTRATIVE CASES:

1. *Action by donor for recovery of value of property donated and for damages covering the cost of fulfilling the condition of the grant which donee failed to perform.*

*Facts:* R, donor, gratuitously granted to E (Province of Cavite) a portion of a fishery owned by R for the construction of a road subject to the condition that E would fill up the space where to build the road with mud taken from the higher portions of the fishery so it would have the same level. E failed to fulfill the condition of the grant.

R brought action for the recovery of the value of the portion of the fishery granted and damages covering the cost of digging up the higher portion of the fishery which E failed to perform.

*Issue:* Is R entitled to the damages claimed?

*Held:* No. The resolution of a contract and its performance are incompatible with each other. Having elected the right to rescind, R cannot at the same time demand the fulfillment of the obligation. If he could recover the cost of the digging, that would amount indirectly to the compliance by E with the obligation. In that manner, R would at the same time be availing himself of the two remedies of resolving the obligation and exacting its fulfillment. *(Osorio vs. Bennet and Prov. Board of Cavite, 41 Phil. 301 [1920].)*

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2. *Action by mortgagee for rescission of mortgage contract and for payment of interest and attorney's fees for non-compliance by debtors.*

*Facts:* For non-compliance on the part of the debtors with the terms of a mortgage contract, the court declared it resolved and ordered them to pay the stipulated 12% interest and 10% attorney's fees.

*Issue:* Under the law, is the allowance of the full stipulated interest and attorney's fees proper?

*Held:* No. When a rescission is granted, it has the effect of abrogating the contract in all its parts. The party seeking resolution cannot have performance as to part and resolution as to the remainder. It results that when the contract in question was resolved, the mortgagee could no longer rely upon the stipulations with respect to the payment of interest and attorney's fees and the sole duty incumbent upon the debtors is to restore what they have received from the creditor, with legal interest from the date when the benefits accruing to them were conferred. *(Po Pauco vs. Siguenza and Aguilar, 49 Phil. 404 [1926].)*

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3. *Buyer opposed appointment of receiver in possession of property sold and secured his dismissal for the purpose of recovering the property from him and subsequently demanded the rescission of the sale.*

*Facts:* S brought action for recovery of a sum of money on a contract, whereby S sold and B bought, his interest in a partnership owned and operated by them. The records disclosed that S, after the sale had been consummated, improperly instituted an action for the dissolution of the partnership and the distribution of its assets, and procured the appointment of a receiver for the partnership property; and that B vigorously opposed the appointment of the receiver and secured his discharge and the dismissal of the complaint praying for the dissolution of the partnership, by asserting his rights to the whole property under the very contract the enforcement of which he later on resisted.

*Issue:* Is B entitled to rescind the contract of sale?

*Held:* No. B, after the receiver was appointed, insisted upon the enforcement of the contract, secured the dismissal of the receiver and the return of the property to his possession and control. Clearly, he could not later on rightly claim that the commission of the property to the hands of a receiver entitled him to rescind the very contract which he elected to enforce for the purpose of taking the property out of the hands of the receiver. *(Yap Unki vs. Chua Jamco, 14 Phil. 602 [1909].)*

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4. *Seller could not deliver title to purchaser because previous sale of same property to former was judicially declared null and void.*

*Facts:* B purchased from S two lots. On complaint of C, court annulled the sale and ordered the issuance of a new title in favor of C. In the meantime, B sold the lots to D who filed a suit for specific performance due to the failure of B to deliver the title and possession to D. The judgment in favor of D, however, could not be executed because of the judgment in another civil case declaring the sale from S to B null and void.

*Issue:* May D still bring an action for rescission of the sale with damages?

*Held:* Yes. The cause of the action to claim rescission arises when the fulfillment of the obligation of B became impossible when the court, in the civil case filed by S, declared the sale to B a complete nullity and ordered the cancellation of the title issued to him. The action must be commenced within four (4) years from the date the judgment in said case became final and executory. *(Ayson-Simon vs. Adamos, 131 SCRA 439 [1984].)*

### Where contract resolved by non-fulfillment or violation of resolutory condition.

Where a contract is subject to a resolutory condition, the non-compliance with the condition resolves the contract by force of law without need of a judicial declaration. *(supra.)* Civilists, however, do not agree on whether the injured party retains the option of demanding fulfillment or rescission of the obligation as provided in Article 1191.

(1) *Without option to demand fulfillment.* — Collin Capitant believes that the creditor retains his right of option. (3 Curso Elemental de Derecho Civil 750.) Manresa says that the stipulated resolution of the contract in case one of the parties does not comply with his undertaking is produced by force of law, but the option of the injured party disappears. (8 Manresa 416.) If the creditor could still demand fulfillment, in spite of the resolution *ipso jure* of the contract, then the resolution would not be mandatory on the creditor and the resolution would produce its effect when the creditor notified the debtor of his decision. (Bañez vs. Court of Appeals, 59 SCRA 15 [1974], citing IV Tolentino, Civil Code of the Philippines, 175.) The creditor, however, may waive any right that might have accrued to him by virtue of the resolution of the contract.

(2) *With option to demand fulfillment.* — Since in a contract of sale, the non-payment of the price (or non-delivery of the thing sold) is a resolutory condition, the remedy of the seller under Article 1191 is to exact fulfillment or to rescind the contract. The non-payment of the purchase price constitutes a very good reason to rescind a sale, for it violates the very essence of a contract of sale. By such failure, the obligation of the seller to convey title does not arise. (Padilla vs. Paredes, 328 SCRA 434 [2000]; Central Bank of the Philippines vs. Bichara, 328 SCRA 807 [2000].) In respect, however, to the sale of immovable property, Article 1191 must be read together with Article 1592 which applies to instances where no stipulation for automatic rescission is made because it says "even though." (Jacinto vs. Kaparas, 209 SCRA 246 [1992], citing Paras, E.L., Civil Code of the Phil. Annotated, Vol. V, 1986 Ed., p. 198.)

Jurisprudence supports the view that when parties to a contract expressly reserve an option to terminate or rescind a contract upon the violation of a resolutory condition, notice of resolution must be given to the other party when such right is exercised. Resort to courts may be necessary when the right involves the retaking of property which is not voluntarily surrendered by the other party. Permitting the use of unqualified force to reposses the property and without condition of notice would allow the lessor/owner to take the law into his own heads. (Campos Assets Corporation vs. Club X.O. Company, 328 SCRA 520 [2000].)

ILLUSTRATIVE CASE:

*Seller did not cancel contract notwithstanding failure of buyer to comply with resolutory condition.*

*Facts:* PHHC (People's Homesite and Housing Corp., a government instrumentality) awarded to B a lot owned by the former pursuant to a conditional contract to sell "subject to the standard resolutory conditions imposed upon grants of similar nature, including the grantee's undertaking to eject trespassers, intruders or squatters on the land and to construct a residential house on the lot and shall complete the same within a period of one (1) year from the signing of this contract . . . the non-compliance with which results in the contract being deemed annulled and cancelled" and that the said cancellation "shall become effective from the date written notice thereof is sent by the PHHC to the applicant."

PHHC approved the transfer of rights of B to C who continued paying the installments on the purchase price of the land.

D sought to nullify the award of the lot in question to C claiming that, being the occupant of the land, he had a preferential right to purchase the same and that the award to B was null and void because B failed to construct a house in the lot within the period of one (1) year from the signing of the contract and, therefore, B acquired no rights that could be transmitted to C. The record does not show that PHHC ever notified B in writing of the cancellation of the contract to sell.

*Issue:* In view of B's failure to comply with the resolutory condition of building a house, did he acquire any right that could be transmitted to C?

*Held:* Yes. The contract to sell was, by virtue of the stipulated resolutory condition, resolved by operation of law. However, the resolution of the contract never became effective as PHHC never notified B of the cancellation of the contract. But even if it be assumed *gratia argumenti* that B acquired no vested right to the lot, PHHC waived the effects of the resolutory condition when it approved the transfer to C. *(Bañez vs. Court of Appeals, 595 SCRA 15 [1974].)*

**Damages recoverable.**

Since the injured party is not entitled to pursue both of the two inconsistent remedies, in estimating the damages to be awarded in case of rescission, only those kinds of damages can be awarded that are compatible or consistent with the idea of rescission, keeping in mind that had the parties opted for specific performance, other kinds of damages would have been called for which are absolutely distinct from those kinds of damages accruing in case of rescission. Of course, in estimating the damages to be awarded in case of specific performance, only those elements of damages can be admitted which are compatible with the conception of specific performance.

(1) It follows that damages which would only be consistent with the conception of specific performance cannot be awarded in an action where rescission is sought, and *vice versa.* Thus, in the common case of the resolution of a contract of sale for failure of the purchaser to pay the stipulated price, the seller is entitled to be restored to the possession of the thing sold with its fruits, if it has already been delivered. If he elects specific performance, he is entitled to the price with interest if it has

not yet been paid. But the seller cannot have both the thing sold and the price, for the resolution of the contract has the effect of destroying the obligation to pay the price, and the performance of the purchaser's obligation to pay the price, has the effect terminating the seller's right to the thing sold. (see Rios and Reyes vs. Jacinto, 49 Phil. 7 [1926]; see Asuncion vs. Evangelista, 316 SCRA 848 [1999].)

(2) In case of rescission for non-delivery of the thing sold, the purchaser is entitled to interest on the amount he has paid.

(3) Where the conditional obligation is deemed not to have existed by reason of the non-fulfillment of the suspensive condition, the award of damages under Article 1191 is unwarranted. (Mortel vs. KASSCO, 348 SCRA 391 [2000].)

**Limitations on right to demand rescission.**

The right to rescind by the injured party (the one who has performed what is incumbent upon him) is not absolute. It is always provisional, *i.e.,* contestable and subject to scrutiny and review by the courts. (Delta Motor Corp. vs. Genuino, 170 SCRA 29 [1989]; Philippine National Construction Corporation vs. Mars Construction Enterprises, Inc., 325 SCRA 624 [2000].)

(1) *Resort to the courts.* — The rescission contemplated by Article 1191 is a judicial rescission. (par. 3.) The injured party has to resort to the courts to assert his rights judicially (*e.g.,* to recover what he has delivered under the contract) for the same article provides that . . . "the *court* shall decree the rescission demanded, unless there be just cause authorizing the fixing of a period." No person can take justice in his own hands and decide by himself what are his rights in the matter. (De la Rama vs. Villarosa, [C.A.] No. 23537-R, Jan. 14, 1960.)

(a) Even a counterclaim or a cross-claim found in the Answer could constitute a judicial demand for rescission that satisfies the requirement of the law. (Iringan vs. Court of Appeals, 366 SCRA 41 [2001]; Bens vs. Lavilao, 366 SCRA 549 [2006].)

(b) The other party must be given an opportunity to be heard. (Republic of the Phil. vs. Hospital San Juan de Dios and Burt, 84 Phil. 820 [1949].) But if such other party does not oppose the extra-

judicial rescission, the same produces legal effects. (Agustin vs. Court of Appeals, 186 SCRA 375 [1990].)

(c) Proof of violation by a party of the contract is a condition precedent to resolution or rescission. It is only when the violation has been established that the contract can be declared resolved or rescinded. (Zulueta vs. Mariano, 111 SCRA 206 [1982].)

(d) It has been held that a directive to take "legal steps" for the rescission of a contract does not necessarily have to be taken as an instruction to bring "legal action." (Bunye vs. Sandiganbayan, 306 SCRA 663 [1997].) The law does not require the injured party to first file suit and wait for a judgment before taking extrajudicial steps to protect his interest; otherwise, he will have to passively sit and watch his damages accumulate during the pendency of the suit until final judgment of rescission is rendered when the law itself requires that he should exercise due diligence to minimize his own damages. (University of the Philippines vs. De Los Angeles, 35 SCRA 102 [1970]; Casiño, Jr. vs. Court of Appeals, 470 SCRA 57 [2005].)

(2) *Power of court to fix period.* — The court has discretionary power to allow a period within which a person in default may be permitted to perform his obligation if there is a just cause for giving time to the debtor[14] (par. 3; Kapisanan Banahaw vs. Dejarme, 55 Phil. 338 [1930]; Gaboya vs. Cui, 38 SCRA 85 [1971].), as where the default incurred was not willful or could be excused in view of the surrounding circumstances (American Far Eastern School of Aviation vs. Ayala Y Cia, [C.A.] No. 1642-R [1948].), or the breach is not substantial. (Massive Construction, Inc. vs. Intermediate Appellate Court, 23 SCRA 1 [1993].) In the absence of any just cause for the court to determine the period of compliance, the court shall decree the rescission. (Central Philippine University vs. Court of Appeals, 246 SCRA 511 [1995].)

[14]An *action for reconveyance* is conceptually different from an action for rescission and the effects that flow from an affirmative judgment in either case would be materially dissimilar in various respects. The judicial resolution of a contract gives rise to mutual restitution which is not necessarily the situation that can arise in an action for reconveyance. Additionally, in an action for rescission (also often termed as resolution) unlike in an action for reconveyance predicated on an extrajudicial rescission (by notarial act; see Note 14), the court instead of decreeing rescission, may authorize for a just cause the fixing of a period. (Olympia Housing, Inc. vs. Panasiatic Travel Corporation, 395 SCRA 298 [2003].)

(3) *Compliance by aggrieved party with his obligation.* — A party to a contract cannot demand performance of the other party's obligation unless he is in a position to comply with his own obligations. Similarly, the right to rescind a contract can be demanded only if a party thereto is ready, willing, and able to comply with his own obligations thereunder. (Binalbagan Tech., Inc. vs. Court of Appeals, 219 SCRA 777 [1993].)

(4) *Right of third persons.* — Rescission creates the obligation of mutual restitution. However, if the thing, subject matter of the obligation, is in the hands of a third person who acted in good faith, rescission is not available as a remedy. (par. 4; see Arts. 1385, 1388.) In such case, the injured party may recover damages from the person responsible for the transfer.

(5) *Slight or substantial violation.* — The general rule is that rescission will not be granted for slight or casual breaches of contract. The violation should be substantial and fundamental as to defeat the object of the parties in making the agreement.[15] (Ang vs. Court of Appeals, 70 SCRA 286 [1989]; Development Bank of the Philippines vs. Court of Appeals, 344 SCRA 492 [2000]; Francisco vs. Court of Appeals, 401 SCRA 594 [2003]; Multinational Village Homeowners Assn. Inc. vs. Ara Security & Surveillance Agency, Inc., 441 SCRA 126 [2004].) The question of whether a breach is substantial depends upon the attendant circumstances and not merely on the percentage of the amount not paid. (Delta Motor Corp. vs. Genuino, *supra;* Universal Food Corp. vs. Court of Appeals, 33 SCRA 1 [1970]; Corpus vs. Alikpala, 22 SCRA 104 [1968]; De Dios vs. Court of Appeals, 212 SCRA 519 [1992]; Central Bank of the Philippines vs. Bichara, 328 SCRA 807 [2000]; Cannul vs. Galang, 459 SCRA 80 [2005].)

[15]In contracts to sell, where ownership is retained by the seller and is not to pass until the full payment of the price (see Arts. 1458[par. 2], 1478.), such payment is a positive suspensive condition, the failure of which is *not a breach, casual or serious,* but simply an event that prevents the obligation of the vendor to convey title from acquiring binding force. (Manuel vs. Rodriguez, 109 Phil. 1 [1960].) In other words, it is irrelevant whether the "infringement" of the contract was casual or serious. (Luzon Brokerage Co., Inc. vs. Maritime Bldg. Co., Inc., 86 SCRA 305 [1978].) There can be no rescission of an obligation that is still non-existent, where the fulfillment of the suspensive condition has not occurred as yet. (Cheng vs. Genato, 300 SCRA 722 [1998].) The breach contemplated in Article 1191 is that of an obligation already existing, not the failure of a condition that prevents that obligation to become binding. Cancellation, not rescission, of the contract to sell is thus the correct remedy. (Sta. Lucia Realty & Development, Inc. vs. Uyecio, 562 SCRA 226 [2008].)

(a) In a case, it was held that delay in payment for a small quantity of molasses for some twenty days was not such a violation of an essential condition of the contract as would warrant rescission for non-performance (Song Fo vs. Hawaiian Phil. Co., 47 Phil. 821 [1925]; see Kapisanan Banahaw vs. Dejarme and Alvero, *supra*; Phil. Amusement Enterprises, Inc. vs. Natividad, 21 SCRA 284 [1967].); nor are delays on four (4) occasions in the payment of rentals for a few days substantial breaches in a contract of lease because the law is not concerned with trifles. (FilOil Refinery Corporation vs. Mendoza, 150 SCRA 632 [1987].)

(b) Where time is not of the essence of the agreement, a slight delay on the part of one party in the performance of his obligation is not a sufficient ground for the rescission of the agreement. (Blando vs. Embestto, 105 Phil. 1164 [1959].)

(c) In a case, where the buyer had already actually paid the sum of P12,500.00 of the total stipulated purchase of P18,000.00 and had tendered payment of the balance of P5,500.00 within the grace period, the buyer was given an additional period within which to complete payment of the purchase price as a matter of equity and justice. (Taguba vs. Vda. de De Leon, 132 SCRA 722 [1984].)

(d) Where the vendee has only a balance of P4,000 net of the total purchase price of P28,000 and was delayed in payment only for one month, equity and justice mandate that he be given an additional period within which to complete payment of the purchase price. (Dignos vs. Court of Appeals, 158 SCRA 375 [1988].) Article 1234 may apply against the unilateral act of a party to rescind a contract. (Angeles vs. Calasanz, 135 SCRA 323 [1985].)

(e) Where the vendee had already paid P26,601.21 (inclusive of interests and penalties) out of the total purchase price of P21,328.00 and the remaining balance was only P9,341.24 which the vendor was willing to pay, the breach held was held slight. To sanction the rescission made by the vendor would work injustice to the vendee and unjustly enrich the vendor at vendee's expense. (Siska Development Corp. vs. Office of the President of the Phils., 231 SCRA 674 [1994].)

(f) Where the ejectment of the occupants of the land sold is made a condition for the compliance by the buyer with his

obligation to pay the balance of the purchase price, the non-fulfillment by the seller of the condition gives the buyer the right to either refuse to proceed with the agreement or to waive that condition in consonance with Article 1545 of the Civil Code. Absent a stipulation therefor, it cannot be said that the parties intended to make its non-fulfillment a ground for rescission. Such failure to deliver actual and physical possession cannot be considered a substantial and fundamental breach of the obligation to sell. (Power Commercial & Industrial Corp. vs. Court of Appeals, 274 SCRA 597 [1997].)

(g) In a case, the lessee sent a letter on January 15, 1986 to the lessor manifesting his intent to exercise the option to purchase the leased property subject of the option within the lease period ending January 30, 1986 but requesting for a six-month extension of the lease contract for the alleged purpose of raising funds intended to purchase the property. The request was denied by the lessor on February 14, 1986. By a letter dated February 18, 1986, the lessee notified the lessor of his desire to exercise the option formally.

It was held that the delay of 18 days was neither "substantial" nor "fundamental" and did not amount to breach that would defeat the intention of the parties when they executed the lease contract with option to purchase. (Carciller vs. Court of Appeals, 302 SCRA 718 [1999].)

(h) The right to rescind is not absolute and will not be granted where there has been substantial compliance by partial payments. (Tayag vs. Court of Appeals, 219 SCRA 480 [1993].) Where a party has already been compensated for the other party's defaults, such defaults cannot be considered as substantial breach that justifies the rescission of a contract. Where a party exercises its options in case of delay or default on the part of the other party, the former waives its right to rescind and is thus estopped from rescinding the contract. (Philippine National Construction Corporation vs. Mars Construction Enterprises, Inc., *supra.*)

(i) Where the vendee expressed his willingness to pay the balance (P1.8 million) of the purchase price one month after it became due, but the offer to pay was conditioned on the performance

by the vendor of additional burdens that had not been agreed upon in the original contract, it cannot be said that the breach committed by the vendee was merely slight or casual as would preclude the exercise of the right to rescind. In effect, the qualified offer to pay was a repudiation of an existing obligation, which was legally due and demandable under the contract of sale. (Velarde vs. Court of Appeals, 361 SCRA 56 [2001].)

(j) The failure of the vendee to pay the balance of the purchase price within 10 years from the execution of the deed of sale does not amount to a substantial breach where it is stipulated in the contract that payment can be made even after 10 years provided the vendee paid 12% interest. (Vda. De Mistica vs. Nagiuat, 418 SCRA 73 [2003].)

(6) *Waiver of right.* — The right to rescind may be waived, expressly or impliedly. Thus, the acceptance by the seller of the land sold as security for the balance of the price is an implied waiver of the right to rescind in case of non-payment by the buyer. His remedy is to recover the balance. (Roman vs. Blas, [C.A.] 51 O.G. 1920, April, 1955.) Where the seller instead of availing of the right to rescind, has accepted delayed payments of installments posterior to the grace periods provided in the contract, he is deemed to have waived and is estopped from exercising the right to rescind normally conferred by Article 1191. (Tayag vs. Court of Appeals, *supra*; Rapanut vs. Court of Appeals, 246 SCRA 323 [1995]; Heirs of P. Escanlar vs. Court of Appeals, *supra.*)

If the right to rescind may be waived, the right to impugn rescission may be lost on the ground of estoppel. In a case, instead of going to court to impugn the automatic and extra-judicial cancellation of the contract to sell by the seller, the buyer sought to enter into a new contract to sell, thereby confirming the validity of the extra-judicial rescission. An unopposed rescission of a contract has legal effects. (People's Industrial & Commercial Corp. vs. Court of Appeals, 281 SCRA 206 [1997].)

(7) *Contract to sell.* — In a contract to sell, the payment of the purchase price is a positive suspensive condition (see Art. 1181.), the failure of which is not a breach, casual or serious, but a situation that prevents the obligation of the vendor to convey title from acquiring

an obligatory force. The breach contemplated in Article 1191 is the obligor's failure to comply with an obligation *already extant*, not a failure of a condition to render binding that obligation. (Odyssey Park, Inc. vs. Court of Appeals, 280 SCRA 253 [1997]; Cheng vs. Genato, 300 SCRA 722 [1998].) In a contract to sell, title remains with the vendor and does not pass on to the vendee until the full payment of the purchase price.

In a contract of sale, the non-payment of the price is a resolutory condition which extinguishes the transaction that for a time existed and discharges the obligations created thereunder. The remedy of the unpaid seller is to seek either specific performance or rescission. (Heirs of P. Escanlar vs. Court of Appeals, 281 SCRA 177 [1997].)

(8) *Sales of real property and of personal property in installments.* — In sales of real property, Article 1592,[16] as impliedly amended by R.A. No. 6552, governs the exercise of the right of rescission. Article 1191 is subordinated to the provision of Article 1592 which speaks of non-payment of the purchase price as a resolutory condition, when applied

[16]Art. 1592. In the sale of immovable property, even though it may have been stipulated that upon failure to pay the price at the time agreed upon the rescission of the contract shall of right take place, the vendee may pay, even after the expiration of the period, as long as no demand for rescission of the contract has been made upon him either judicially or by a notarial act. After the demand, the court may not grant him a new term.

Art. 1593. With respect to movable property, the rescission of the sale shall of right take place in the interest of the vendor, if the vendee, upon the expiration of the period fixed for the delivery of the thing, should not have appeared to receive it, or having appeared, he should not have tendered the price at the same time, unless a longer period has been stipulated for its payment. (1505)

*Note:* In sales of real property, Article 1592 is controlling since it deals specifically with sale of immovable property. (Luzon Brokerage Co., Inc. vs. Maritime Co., Inc., 86 SCRA 305 [1978].) The article, however, does not apply to sales on installments of real property in which the parties have laid down the procedure to be followed in the event the vendee failed to fulfill his obligation. (Albea vs. Inquimboy, 80 Phil. 477 [1948].) Thus, where the contract to sell a parcel of land expressly provides that it shall be deemed annulled and cancelled and the seller shall be at liberty to take possession of said property and dispose of the same to any other person upon default of the buyer to pay the installments due, there is no contract to rescind in court from the moment the buyer defaults in the timely payment of the installments, the contract between the parties in such case being deemed *ipso facto* rescinded. (Torralba vs. De los Angeles, 96 SCRA 69 [1980].) R.A. No. 6552 (Realty Installment Buyer's Protection Act.), a special law that governs transactions that involve, subject to certain exceptions, the sale on installment basis of real property, modifies the terms and application of Article 1592. It requires that the notice of cancellation or demand for rescission must be by notarial act. In addition, the seller is required to refund to the buyer the cash surrender value of the payments on the property.

to sales of immovable property. (Santos vs. Court of Appeals, 337 SCRA 67 [2000].)

With respect to the sales of personal property on installments, Articles 1484, 1485, and 1486 are applicable.[17]

(9) *Judicial compromise.* — Article 1191 applies only to reciprocal obligations in general and not to obligations arising from a judicial compromise. Judgment upon agreement of the parties is more than a mere contract binding upon them. Having the sanction of the court and entered as its determination of a controversy it has the force and effect of any other judgment. Moreover, the rule is that a judgment rendered in accordance with a compromise agreement is immediately executory as there is no appeal from such judgment. (Prudence Realty and Development Corp. vs. Court of Appeals, 231 SCRA 379 [1994].)

(10) *Arbitration clause in a contract.* — The act of treating a contract as rescinded on account of infractions by the other contracting party is valid albeit provisional as it can be judicially assailed. The right cannot be exercised where there is a valid stipulation on arbitration. Thus, neither of the parties can unilaterally treat the contract as rescinded where an arbitration clause in a contract is availing since whatever infractions or breaches by a party or differences arising from the contract must be brought first and resolved by arbitration, and not through an extrajudicial rescission or judicial action. (Korea Technologies, Co., Ltd. vs. Lerma, 542 SCRA 1 [2008].)

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[17]Art. 1484. In a contract of sale of personal property the price of which is payable in installments, the vendor may exercise any of the following remedies:

(1) Exact fulfillment of the obligation, should the vendee fail to pay;

(2) Cancel the sale, should the vendee's failure to pay cover two or more installments;

(3) Foreclose the chattel mortgage on the thing sold, if one has been constituted, should the vendee's failure to pay cover two or more installments. In this case, he shall have no further action against the purchaser to recover any unpaid balance of the price. Any agreement to the contrary shall be void. (1454-A-a)

Art. 1485. The preceding article shall be applied to contracts purporting to be leases of personal property with option to buy, when the lessor has deprived the lessee of the possession or enjoyment of the thing. (1454-A-a)

Art. 1486. In the cases referred to in two preceding articles, a stipulation that the installments or rents paid shall not be returned to the vendee or lessee shall be valid insofar as the same may not be unconscionable under the circumstances. (n)

**Rescission of contract without previous judicial decree.**

(1) *Where automatic rescission expressly stipulated.* — The parties, may validly enter into an agreement that violation of the terms of the contract would cause cancellation thereof even without judicial intervention or permission or termination. This stipulation is in the nature of a resolutory condition. (University of the Phils. vs. De los Angeles, 35 SCRA 102 [1970]; Consing vs. Jamandre, 64 SCRA 1 [1975]; Froilan vs. Pan Oriental Shipping Co., 12 SCRA 276 [1964]; Heirs of the Late Justice J.B.L. Reyes vs. Court of Appeals, 338 SCRA 282 [2000].) In a contract of sale, the unilateral rescission is usually in the form of a stipulation granting the seller the right to forfeit installments or deposits made by the buyer in case of the latter's failure to make full payment on the stipulated date. (Associated Bank vs. Pronstroller, 558 SCRA 113 [2008].)

There is nothing in Article 1191 which prohibits the parties from entering into such stipulation which is in the nature of a facultative resolutory condition. (Pangilinan vs. Court of Appeals, 279 SCRA 560 [1997]; Enrile vs. Court of Appeals, 29 SCRA 504 [1969]; Lopez vs. Commissioner of Customs, 37 SCRA 327 [1971]; Luzon Brokerage Co., Inc. vs. Maritime Bldg. Co., Inc., 43 SCRA 93 [1972].) Obligations arising from contracts have the force of law between the constructing parties and should be complied with in good faith. (Art. 1159.)

(a) Where the contract itself contains such a stipulation the right to rescind is not "implied" but expressly recognized. Hence, Article 1191 is not applicable. Judicial action for rescission is not necessary where the contract provides on automatic rescission in case of breach. But the act of a party in treating a contract as cancelled should be made known to the other. For such act is always provisional. It is subject to review by the courts in case the alleged defaulter brings the matter to the proper courts. (Gomez vs. Court of Appeals, 340 SCRA 720 [2000]; Sison vs. Court of Appeals, 164 SCRA 339 [1988]; Cheng vs. Genato, 300 SCRA 722 [1998]; Liu vs. Loy, Jr., 405 SCRA 316 [2003]; Dijamco vs. Court of Appeals, 440 SCRA 190 [2004]; Lorenzo Shipping Corp. vs. BJ Marthel International, Inc., 443 SCRA 163 [2004].)

(b) Resort to judicial action by the injured party is still necessary to recover whatever he may have delivered to the other party under the contract if the latter opposes the rescission. A contract between the parties providing for extrajudicial rescission and recovery of possession of property in case of breach has legal effect only where the other party does not oppose the rescission. Where it is validly objected to, a judicial determination of the issue is still necessary. (Zulueta vs. Mariano, 111 SCRA 206 [1982]; Subic Bay Metropolitan Authority vs. Universal International Group of Taiwan, 340 SCRA 359 [2000].) In other words, the resolution of reciprocal contracts may be made extrajudicially unless impugned in court. (Palay, Inc. vs. Clave, 124 SCRA 641 [1983].) Where, however, the other party does not deny that there was such a breach but he merely argues that the stipulation allowing a rescission and a recovery of possession is void, the injured party may validly enforce such stipulation. (Subic Bay Metropolitan Authority vs. Universal International Group of Taiwan, 340 SCRA 359 [2000].)

In any case, the creditor may still choose specific performance instead of rescission unless the contrary is stipulated.

(c) The right of "automatic rescission" stipulated in a contract is subject to waiver. Thus, in a case, the right was held waived by reason of the many extensions granted the vendee by the vendor who never called attention to the provision on "automatic extension." (Pilipinas Bank vs. Intermediate Appellate Court, 151 SCRA 546 [1987].)

(2) *Where contract still executory.* — In the absence of stipulation to the contrary, the *right* to rescind a contract must be invoked judicially; it cannot be exercised solely on a party's own judgment that the other has committed a breach of the obligation. (Tan vs. Court of Appeals, 175 SCRA 656 [1989].) However, although there is no performance yet by both parties, but one is ready and willing to comply with what is incumbent upon him, and the other is not (see Art. 1169, last par.), the willing party may, by his own declaration, rescind the contract without a previous judicial decree of rescission. In such case, it is not necessary that there be a stipulation providing for automatic rescission.

**Procedure where extrajudicial rescission contested.**

(1) *With stipulation for automatic revocation.* — In contracts providing for automatic revocation, judicial intervention is necessary not for purposes of obtaining a judicial declaration rescinding a contract already deemed rescinded by virtue of an agreement providing for rescission even without judicial intervention, but in order to determine whether or not rescission was proper. Where such propriety is sustained, the decision of the court will be merely declaratory of the revocation, but it is not in itself the revocatory act. (Roman Catholic Archbishop of Manila vs. Court of Appeals, 198 SCRA 300 [1991]; Pangilinan vs. Court of Appeals, 279 SCRA 590 [1997].)

In any case, where the other party denies that rescission is justified, he is free to resort to judicial action to question the rescission. Then, should the court, after due hearing, decide that the resolution of the contract was not warranted, the responsible party will be sentenced to damages; in the contrary case, the resolution will be affirmed, and the consequent indemnity awarded to the party prejudiced. But where the other party does not contest the extrajudicial declaration of rescission, the same shall produce legal effect although subject to judicial invalidation unless attack thereon should become barred by acquiescence, estoppel, or prescription. (University of the Phils. vs. De los Angeles, *supra*; Luzon Brokerage Co., Inc. vs. Maritime Bldg. Co., 43 SCRA 93 [1972]; Angeles vs. Calasanz, 135 SCRA 323 [1985]; Lim vs. Court of Appeals, 182 SCRA 564 [1990].)

(2) *Without stipulation for automatic revocation.* — Even without express stipulation providing for automatic rescission, a contracting party has the *power* to rescind reciprocal contracts extrajudicially but, as already observed, in case of abuse or error by the rescinder, the other party is not barred from questioning in court such abuse or error. In other words, the party who deems the contract violated may consider it resolved or rescinded, and act accordingly, without previous court action, but he proceeds at his own risk. For where the extrajudicial resolution is contested, only the final award of a court of competent jurisdiction can conclusively settle whether the resolution or action taken was proper or not. *(Ibid;* Platinum Plans Phils., Inc. vs. Cucueco, 418 SCRA 156 [2006].) If the other party does not oppose the extra-judicial rescission, then it shall have legal effect; its silence suggests an

admission of the veracity and validity of the rescinding party's claim. (Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995]; Goldenrod, Inc. vs. Court of Appeals, 299 SCRA 141 [1998].)

**Action for rescission not required upon breach of compromise agreement.**

A *compromise* is an agreement between two or more persons who, for preventing or putting an end to a lawsuit, adjust their respective positions by mutual consent in the way they feel they can live with. Reciprocal concessions are the very heart and life of every compromise agreement where each party approximates and concedes in the hope of gaining balance by the danger of losing. (Genova De Castro, 407 SCRA 165 [2003].) The purpose of the compromise is precisely to replace and terminate controverted claims. (Santos Ventura Hocorma Foundation, Inc. vs. Santos, 441 SCRA 472 [2004].)

The party aggrieved by the breach of a compromise agreement (see Art. 2028.) may, enforce or, if he chooses, bring the suit contemplated or involved in his original demand, as if there had never been any compromise agreement, without bringing an action for rescission thereof. He need not seek a judicial declaration, for he may "regard" the compromise agreement already "rescinded." This is clear from the language of Article 2041 which provides: "If one of the parties fails or refuses to abide by the compromise, the other party may either enforce the compromise or regard it as rescinded and insist upon his original demand."

Article 2041 confers upon the party concerned not a "cause" for rescission (see Art. 2039.), or right to "demand" rescission of a compromise, but the "authority" not only to "regard it as rescinded," but also, to "insist upon the original demand." (Leonor vs. Sycip, 1 SCRA 1215 [1961].)

**Rescission distinguished from termination.**

In legal contemplation, the rescission of a contract is not equivalent to its termination.

Rescission has likewise been defined as the "unmaking of a contract, or its *undoing from the beginning, and not merely its termination*." Rescission may be effected by both parties by mutual agreement; or

unilaterally by one of them declaring a rescission of contract without the consent of the other, if a legally sufficient ground exists or if a decree of rescission is applied for before the courts.

On the other hand, termination refers to an "end in time or existence; a close, cessation or conclusion." When an agreement is rescinded, it is deemed inexistent, and the parties are returned to their status *quo ante*. Hence there is mutual restitution of benefits received. However, when it is terminated, it is deemed valid at its inception. Prior to termination the contract binds the parties who are thus obliged to observe its provisions. The consequences of termination may be anticipated and provided by the contract. As long as the terms of the contract are not contrary to law, morals, good customs, public order or public policy they shall be respected by the courts. (Pryce Corporation vs. PAGCOR, 458 SCRA 164 [2005].)

**ART. 1192. In case both parties have committed a breach of the obligation, the liability of the first infractor shall be equitably tempered by the courts. If it cannot be determined which of the parties first violated the contract, the same shall be deemed extinguished, and each shall bear his own damages. (n)**

### Where both parties guilty of breach.

The above article contemplates two situations.

(1) *First infractor known*. — One party violated his obligation; subsequently, the other also violated his part of the obligation. In this case, the liability of the first infractor should be equitably reduced.[18] Thus, where a bank failed to release the entire approved loan (P80,000), but the borrower also failed to pay the partial loan release (P17,000) he received after it fell due, both are in default and their respective

[18]"Under this provision, the second infractor is not liable for damages at all. The damages for the second breach which would have been payable by the second infractor to the first infractor, being comprensated instead by the mitigation of the first infractor's liability for damages arising from his earlier breach. The first infractor, on the other hand, is liable for damages, but the same shall be equitably tempered by the courts, since the second infractor also derived or thought he would derive some advantage by her own act or neglect." x x x Article 1192 does not really exculpate the second infractor from liability, as the second infractor is actually punished for his breach by mitigating the damages to be awarded to him from the previous breach of the other party. (Ong vs. Bogñalbal, 501 SCRA 490 [2006].)

liability for damages shall be offset equitably, exclusive of the interest due on the overdue loan portion (P17,000) since the borrower derived benefit for its use. (see Central Bank of the Phils. vs. Court of Appeals, 139 SCRA 46 [1985].)

(2) *First infractor cannot be determined.* — One party violated his obligation followed by the other, but it cannot be determined which of them was the first infractor. The rule is that the contract shall be deemed extinguished and each shall bear his own damages. This means that the contract shall not be enforced. In effect, the court shall not provide remedy to either of the parties, who must suffer the damages allegedly sustained by them.

> "The above rules are deemed just. The first one is fair to both parties because the second infractor also derived, or thought he would derive, some advantage by his own act or neglect. The second rule is likewise just because it is presumed that both at about the same time tried to reap some benefit." (Report of the Code Commission, p. 130.)

It has been held that when both parties to a transaction are mutually negligent in the performance of their obligations, the fault of one cancels the negligence of the other and their rights and obligations may be determined equitably under the law proscribing unjust enrichment. (Rodzssen Supply Co., Inc. vs. Far East Bank & Trust Co., 357 SCRA 618 [2001]; see Art. 1160.) Under Article 1192, "the liability of the first infractor shall be equitably tempered by the courts" but it is for the courts, in the exercise of their sound discretion, to decide what is equitable under the circumstances.[19] In other words, the mitigation

[19] "Article 1192, in making the first infractor liable for mitigated damages and in exempting the second infractor from liability for damages, presupposes that the contracting parties are on equal footing with respect to their reciprocal principal obligations. Actual damages representing deficiencies in the performance of the principal obligation should be taken out of the equation.

For example, S sells 10 boxes of mangoes to B for P1,000 each (or a total of P10,000). B made a partial payment of P5,000, defaulting in the payment of the other P5,000, but S had *previously* delivered only 7 boxes and defaulted in the delivery of the other 3 boxes. If the parties did not eventually perform their respective obligations (such that there is breach and not mere delay), the courts should first put the parties in equal footing with respect to their reciprocal principal obligations. Hence, B, the second infractor, would indeed be exempt from the payment of damages, but this exemption should only be applied after she pays P2,000 in actual damages representing the excess of S's partial performance of her reciprocal principal obligation." *(Ibid.)*

of the damages to be awarded to the second infractor is subject to the discretion of the court, depending of what is equitable under the circumstances.

ILLUSTRATIVE CASES:

1. *Right of a party guilty of breach of his obligation to specific performance or to recovery of damages by reason of such breach.*

*Facts:* X agreed to construct a house for Y, who was to furnish the materials. Before the house was completed, it was destroyed by a storm, a fortuitous event. Y brought action for the recovery of a sum of money allegedly due on the building contract. X counterclaimed for labor and materials furnished by him. The evidence disclosed that each of the parties had more or less failed to comply with his respective obligation.

The lower court balanced the failure of X and Y against each other, and allowed judgment for X for the balance. Y appealed.

*Issue:* Did the lower court commit an error in not declaring expressly that the parties are absolved from further liability?

*Held:* No error is committed (under the provisions of Art. 1191.) since by the very terms of the judgment the parties must necessarily be absolved from any further action or liability upon the contract. Y did not perform the undertaking which he was bound by the terms of his agreement to perform. Consequently, he is not entitled to insist upon the performance of the contract by X or to recover damages by reason of his own breach.

The lower court found that inasmuch as Y had actually furnished material to X in the sum of P132.00, which X had used, that Y was entitled to a judgment against X for that amount; and X had expended in labor and material the sum of P500.00 for additional work and labor performed upon the additions made to the original building, at the request of Y, that X was entitled to a judgment against Y for that sum; and, therefore, that X should recover from Y the sum of P368.00, being the difference between P500.00 and P132.00.

This judgment of the lower court absolved each party from any further liability upon the said contract. (*Bosque vs. Yu Chipco, 14 Phil. 95 [1909]*; see Albert vs. University Publishing Co., 103 Phil. 351 [1958] cited under Art. 1191.)

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2. *Liability of a party who is guilty of breach to pay interest.*

*Facts:* S (corporation) and B entered into a contract whereby S agreed to sell and install, for the consideration of P52,000.00, a processing machinery and equipment at B's place in Lanao within a period of 70 working days from the date of the signing of the contract. In compliance with the contract, B made a partial payment of P15,750.00 leaving a balance of P36,750.00 which shall be payable in 12 monthly installments.

Under paragraph 6 of the contract, B undertook to supply the building wherein shall be housed the machinery and equipment, laborers, foundation materials, food, and effective water system. During the installation of said machinery and equipment, S was forced to provide the necessary materials and labor and advance whatever expenses had been made for that purpose with previous knowledge and consent given by B because the latter was short of funds during that time. It took S one (1) year and three (3) months to complete the installation.

B refused to pay the balance due and all expenses (P19,628.93) because of the failure of S to complete the installation within the stipulated period and place the machinery and equipment in satisfactory running conditions as guaranteed by S in the contract.

S brought an action against B for rescission of the contract after mutual restitution by the parties with provision for damages in its favor. B, in his answer, likewise sought the rescission of the contract after mutual restitution by the parties, but with provision for the payment by S of freight charges that may be incurred due to such restitution and with the award of damages in his favor.

It was established that both parties violated the terms and conditions of the contract: B, by failing to comply with his obligations under paragraph 6 of the contract, and S, by installing machinery and equipment that were basically defective and inadequate. It could not be determined, however, as to who was the first infractor in point of time.

The trial court granted rescission but held that the parties should bear his/its own damages. Applying Article 1192, it ordered B to return to S the machinery and equipment and bear the transportation expense thereof to the port of Cotabato, S to bear the freight charges thereof for its shipment to Manila, and to pay S P19,628.93 with interest thereon at the rate of 6% from the date of the filing of the complaint, and S to return the partial payment of P15,750.00. It made no pronouncement as to damages and costs.

*Issue:* Is the lower court's decision correct?

*Held:* Yes, with the only modification that B was not liable to pay interest on the sum of P19,628.93, for to hold otherwise would be in conflict with the rule that each party must bear his/its own damages. *(Grace Park Engineering Co., Inc. vs. Domingo, 107 SCRA 266 [1981].)*

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## SECTION 2. — *Obligations with a Period*

**ART. 1193. Obligations for whose fulfillment a day certain has been fixed, shall be demandable only when that day comes.**

**Obligations with a resolutory period take effect at once, but terminate upon arrival of the day certain.**

**A day certain is understood to be that which must necessarily come, although it may not be known when.**

**If the uncertainty consists in whether the day will come or not, the obligation is conditional, and it shall be regulated by the rules of the preceding Section. (1125a)**

### Meaning of obligation with a period.

An *obligation with a period* is one whose consequences are subjected in one way or another to the expiration of said period or term. (8 Manresa 158; see Lirag Textiles, Inc. vs. Court of Appeals, 63 SCRA 374 [1975].)

### Meaning of period or term.

A *period* is a future *and* certain event upon the arrival of which the obligation (or right) subject to it either arises or is terminated. It is a day certain which must necessarily come (like the year 2005; next Christmas), although it may not be known when, like the death of a person. (Art. 1193, par. 3.)

### Period and condition distinguished.

The differences are as follows:

(1) *As to fulfillment.* — A period is a certain event which must happen sooner or later at a date known beforehand, or at a time which cannot be determined, while a condition is an uncertain event;

(2) *As to time.* — A period refers only to the future, while a condition may refer also to a past event unknown to the parties;

(3) *As to influence on the obligation.* — A period merely fixes the time for the efficaciousness of the obligation. If suspensive, it cannot prevent the birth of the obligation in due time; if resolutory, it does not annul, even in fiction, the fact of its existence. On the other hand, a condition causes an obligation to arise or to cease. Because of this difference, a period does not carry with it, except when there is a stipulation expressly made by the parties, the same retroactive consequences that follow a condition (see 8 Manresa 159-160.);

(4) *As to effect, when left to debtor's will.* — A period which depends upon the will of the debtor empowers the court to fix the duration thereof (Art. 1197, par. 2.), while a condition which depends upon the sole will of the debtor invalidates the obligation (Art. 1182.); and

(5) *As to retroactivity of effects.* — Unless there is an agreement to the contrary, the arrival of a period does not have any retroactive effect, while the happening of a condition has retroactive effect.

Like a condition (see Art. 1183.), a period must be possible. If the period is impossible (*e.g.*, February 30, because it will never come; within 24 hours to deliver a ship in foreign country because it is too short), the obligation is void.

ILLUSTRATIVE CASES:

1. *A term was fixed for delivery of goods but both parties recognized that such delivery was so uncertain in view of possible contingencies known to them.*

*Facts:* S and B entered into various contracts whereby the former obligated himself to sell, and the latter, to purchase, steel tanks, electric motors, etc., the same to be shipped from the U.S. within fixed periods of time. B refused to receive them and pay the prices stipulated as they arrived beyond the time fixed. In all the contracts there is a final clause that S was not responsible for delays caused by fires, riots, strikes, or other causes entirely beyond the control of S.

*Issue:* Is the obligation of S conditional or one with a period?

*Held:* (1) *No definite date was fixed for delivery.* — Under these stipulations, it cannot be said that any definite date was fixed for the delivery of the machinery.

At the time of the execution of the contracts, the parties were not unmindful of the contingency of the U.S. not allowing the export of

the goods in view of the world war, or of the fact that other unforeseen circumstances therein stated might prevent it. As the export of the machinery in question was contingent upon S obtaining permission of the U.S. government, the delivery was subject to a condition the fulfillment of which depended not only on the effort of S but upon the will of third persons who could in no way be compelled to fulfill the condition.

(2) *Delivery must be made within a reasonable time.* — With the above in mind, the term which the parties attempted to fix was so uncertain that the obligation must be regarded as conditional. In cases like this, the obligor will be deemed to have sufficiently performed his part of the obligation, if he has done all that was in his power even if the condition has not been fulfilled in reality. When the time of delivery is not fixed or is stated in general and indefinite terms, time is not of the essence of the contract. In such cases, the delivery must be made within a reasonable time.

Taking into account the above circumstances, the goods in question were brought to Manila by S within a reasonable time and consequently, B must pay their price. *(Smith Bell & Co. vs. Sotelo Matti, 44 Phil. 875 [1923].)*

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2. *Existence of obligation to pay is recognized and merely the exact date for payment is undetermined.*

*Facts:* X, owner of a mining claim, appointed Y as attorney-in-fact to enter into a contract with any individual or juridical person for the exploration and development of said claim on a royalty basis. Y himself embarked upon the exploitation of the claim. Subsequently, X revoked the authority granted by him to Y who assented thereto subject to certain conditions. As a result, a document was executed wherein Y transferred to X all of Y's rights and interests over the "24 tons of iron ore, more or less" that Y had already extracted from the mineral claims in consideration of the sum of P75,000.00, P10,000.00 of which was paid upon the signing of the agreement, and "the balance of P65,000.00 will be paid from and out of the first letter of credit covering the first shipment of iron ores and of the first amount derived from the local sale of iron ore" from said claims.

To secure the payment of the balance, X executed in favor of Y a surety bond. No sale of approximately 24,000 tons of iron ore had been made nor had the balance of P65,000.00 been paid to Y.

*Issue:* Is the shipment or local sale of the iron ore a condition precedent (or suspensive condition) to the payment of the balance, or only a suspensive period or term?

*Held:* The obligation of X is one with a term. The words of the contract express no contingency in the buyer's obligation to pay. There is no uncertainty that the payment will have to be made sooner or later; what is undetermined is merely the exact date at which it will be made. By the very terms of the contract, therefore, the existence of the obligation to pay is recognized; only its maturity or demandability is deferred.

Furthermore, to subordinate X's obligation to the sale or shipment of the ore as a condition precedent, would be tantamount to leaving the payment at his discretion (Art. 1182.), for the sale or shipment could not be made unless he took steps to sell the ore. *(Gaite vs. Fonacier,*[1] *2 SCRA 831 [1961].)*

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3. *Right of debtor to make use of period made subject to fulfillment of certain conditions.*

*Facts:* According to the contract entered into between R (mortgagor) and E (mortgagee), the obligation of R was to pay the debt in yearly installments on a fixed day of each year, until it has been fully satisfied but in case of non-fulfillment of any of the stipulations and conditions of the mortgage, such as the failure to pay the annual installments, E could declare the said stipulations and conditions violated and proceed to the foreclosure of the mortgage in accordance with law.

*Issue:* What is the effect of the non-fulfillment of the conditions of the contract?

*Held:* It renders the period ineffective, and makes the obligation demandable at the will of E, the creditor. (*Phil. National Bank vs. Lopez Vito, 52 Phil. 41 [1928];* see Art. 1198.)

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4. *Effect of happening of fortuitous event on the running of period agreed upon for fulfillment of obligation.*

*Facts:* X and Y entered into a milling contract whereby X agreed that the sugarcane which Y will produce will be milled by X for a period of thirty years. It was stipulated that in case of a fortuitous event, the contract shall be deemed suspended during said term.

Y failed to deliver sugarcane to X for six years, four years during the war and two years when his mill was being rebuilt.

*Issue:* May Y be compelled to deliver sugar cane to X for six more

[1]Also cited under Articles 1198 and 1378.

years after the expiration of thirty years to make up for what Y failed to deliver?

*Held:* No. The stipulation does not mean that the happening of a fortuitous event stops the running of the period agreed upon. It only relieves the parties from the fulfillment of their respective obligations during that time. X, not being entitled to demand from Y the performance of the latter's part of the contract which was impossible at the time it became due, cannot later on demand its fulfillment. The prayer of X, if granted, would in effect be an extension of the term of the contract entered into by them. *(Victorias Planters vs. Victorias Milling Co., 97 Phil. 318 [1955].)*

## Kinds of period or term.

They are:

(1) *According to effect:*

(a) *Suspensive period (ex die).* — The obligation begins only from a day certain upon the arrival of the period (Art. 1193, par. 1.); and

(b) *Resolutory period (in diem).* — The obligation is valid up to a day certain and terminates upon the arrival of the period. (par. 2.)

EXAMPLES:

*Ex die:*

(1) "I will pay you 30 days from today." (or on Jan. 1 next year, or at the end of this month.) Here, what is suspended is not the obligation itself (or right acquired) but merely its demandability.

(2) "I will support you from the time your father dies." Here, the uncertainty consists not in whether the day (death) will come or not, but only in the exact date or time of its taking place. (pars. 3 and 4, Art. 1193.)

(3) "I will pay you when my means permit me to do so." This is considered by law as an obligation with a period. (Art. 1180.)

*In diem:*

(1) "I will give you P1,000.00 a month until the end of the year."

(2) "I will support you until you die."

(2) *According to source:*

(a) *Legal period.* — When it is provided for by law;

(b) *Conventional or voluntary period.* — When it is agreed to by the parties (Art. 1196.); and

(c) *Judicial period.* — When it is fixed by the court. (Art. 1197.)

(3) *According to definiteness:*

(a) *Definite period.* — When it is fixed or it is known when it will come (Art. 1193, par. 3.); and

(b) *Indefinite period.* — When it is not fixed or it is not known when it will come. Where the period is not fixed but a period is intended, the courts are usually empowered by law to fix the same. (see Art. 1197.)

**ART. 1194. In case of loss, deterioration or improvement of the thing before the arrival of the day certain, the rules in Article 1189 shall be observed. (n)**

### Effect of loss, deterioration, or improvement before arrival of period.

See comments under Article 1189.

**ART. 1195. Anything paid or delivered before the arrival of the period, the obligor being unaware of the period or believing that the obligation has become due and demandable, may be recovered, with the fruits and interests. (1126a)**

### Payment before arrival of period.

Article 1195 applies only to obligations to give. It is similar to Article 1188, paragraph 2, which allows the recovery of what has been paid by mistake before the fulfillment of a suspensive condition. The creditor cannot unjustly enrich himself by retaining the thing or money received before the arrival of the period.

Under the former provision, the debtor could recover only the fruits or interests but not the thing or sum given or paid in advance. This rule was deemed unjust and "contrary to the manifest intention of the parties." (see Report of the Code Commission, pp. 130-131.)

### Debtor presumed aware of period.

The presumption, however, is that the debtor knew that the debt was not yet due. He has the burden of proving that he was unaware of the period. Where the duration of the period depends upon the will of

the debtor (see Art. 1197, par. 3.), payment by him amounts, in effect, to his determination of the arrival of the period.

The obligor may no longer recover the thing or money once the period has arrived but he can recover the fruits or interests thereof from the date of premature performance to the date of maturity of the obligation.

EXAMPLE:

D owes C P2,000.00 which was supposed to be paid on December 31 this year. By mistake, D paid his obligation on December 31 last year.

Assuming that today is June 30, D can recover the P2,000.00 plus P120.00, which is the interest for one half year at the legal rate of 12%[2] or a total of P2,120.00. But D cannot recover, except the interest, if the debt had already matured.

Neither can there be a right to recovery if D had knowledge of the period. The theory under *solutio indebiti* obviously will not apply. (Art. 2154.) D is deemed to have impliedly renounced the period.

### No recovery in personal obligations.

Article 1195 has no application to obligations to do or not to do because as to the former, it is physically impossible to recover the service rendered, and as to the latter, as the obligor performs by not doing, he cannot, of course, recover what he has not done. (see 8 Manresa 166.)

**ART. 1196. Whenever in an obligation a period is designated, it is presumed to have been established for the benefit of both the creditor and the debtor, unless from the tenor of the same or other circumstances it should appear that the period has been established in favor of one or of the other. (1127)**

### Presumption as to benefit of period.

In an obligation subject to a period fixed by the parties, the period is presumed to have been established for the benefit of both the creditor and the debtor. This means that before the expiration of the period, the debtor may not fulfill the obligation and neither may the creditor demand its fulfillment without the consent of the other especially if the latter would be prejudiced or inconvenienced thereby.

[2]See C.B. Circular No. 416, cited under Article 1175.

In a reciprocal contract like a lease, the period must be deemed to have been agreed upon for the benefit of both parties, absent language showing that the term was deliberately set for the benefit of the lessee or the lessor alone. (Fernandez vs. Court of Appeals, 160 SCRA 577 [1988]; Buce vs. Court of Appeals, 332 SCRA 151 [2000].)

The presumption, of course, is rebuttable. (Osorio vs. Salutillo, 87 Phil. 356 [1950].)

EXAMPLE:

On January 1, D borrowed from C P10,000.00 payable on December 31 at 18% interest.

D cannot pay before December 31 without the consent of C. Neither can C compel D to pay before the expiration of the term. It is presumed that the period designated, which is December 31, has been established for the benefit of both. D is benefited because he can use the money for one year. C is also benefited because of the interest the money would earn for one year.

In a contract of loan with interest, the term is generally for the benefit of both the lender and the borrower. (see Bachrach Garage & Taxicab Co. vs. Golingco, 39 Phil. 912 [1919].) This is also the case even where there is no interest stipulated but the creditor receives, in place of interest, other benefits by reason of the period. (Osorio vs. Salutillo, *supra*.)

Obviously in the above example, D can pay C before December 31 provided the payment includes the interest for one (1) year. (see, however, De Leon vs. Santiago Syjuco, Inc., 90 Phil. 311 [1951]; Nicolas vs. Matias, 89 Phil. 126 [1951].) Where, however, the obligation of D is to deliver say, 100 cavans of rice, C cannot be compelled to accept performance before the expiration of the period especially if he would be prejudiced or inconvenienced thereby.

ILLUSTRATIVE CASES:

1. *Prescriptive period where term is for the benefit of both creditor and debtor.*

*Facts:* D secured a loan from C with interest, the term of which was one (1) year. As security, D pledged his jewelry in writing to C. Within 11 years from the execution of the pledge, D brought action against C to recover the jewelry, tendering the corresponding principal and the corresponding interests.

C contended that the action has prescribed since it was brought after 10 years from date of the execution of the pledge inasmuch as D could

have paid the loan and recovered the jewelry within the one-year term. If the contention of C be sustained, then D's action was already barred although it was brought within ten (10) years from the expiration of the one-year term.

*Issue:* Is the theory of C tenable?

*Held:* No. This is a case of a loan wherein the term benefits D by the use of the money as well as C by the interest. Therefore, the action for the recovery of the jewelry pledged arose only after the lapse of the one (1) year period for purposes of the computation of the period of prescription of said action. It follows that C is in error. *(Sarmiento and Villasenor vs. Javellana, 43 Phil. 880 [1920].)*

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2. *Under the contract of lease for a period of 15 years, the lease shall be "subject to renewal for another ten (10) years."*

*Facts:* Petitioner B leased a parcel of land, for a period of 15 years to commence on June 1, 1979 and to end on June 1, 1994 "subject to renewal for another ten (10) years, under the same terms and conditions." B then constructed and paid the required monthly rental. Private respondent T, lessor, demanded gradual increases in the rental which B paid. In 1993, B refused to pay any more increase in rental.

According to T, the phrase in the lease contract authorizing renewal for another 10 years does not mean automatic renewal, rather, it contemplates a mutual agreement between the parties. On the other hand, B maintains the stipulation in the contract allowing the lessee to construct buildings and improvements, her filing of the complaint before the expiration of the initial 15-years term, for specific performance with consignation with prayer to accept the rentals in accordance with the lease contract, and T's acceptance of the increased rental are contemporaneous and subsequent acts that signify the intention of the parties to renew the contract.

*Issue:* The basic issue is the correct interpretation of the contract provision in question.

*Held:* (1) *Provision on renewal unclear.* — "The phrase "subject to renewal for another ten (10) years" is unclear on whether the parties contemplated an automatic renewal or extension of the term, or just an option to renew the contract; and if what exists is the latter, who may exercise the same or for whose benefit it was stipulated.

In this jurisdiction, a fine delineation exists between renewal of the contract and extension of its period. Generally, the renewal of a contract connotes the death of the old contract and the birth or emergence of a new

one. A clause in a lease providing for an extension operates of its own force to create an additional term, but a clause providing for a renewal merely creates an obligation to execute a new lease contract for the additional term. As renewal of the contract contemplates the cessation of the old contract, then it is necessary that a new one be executed between the parties."

(2) *Lease period deemed to have been fixed for the benefit of both parties.* — "In the case at bar, it was not specifically indicated who may exercise the option to renew, neither was it stated that the option was given for the benefit of herein petitioner. Thus, pursuant to the Fernandez ruling and Article 1196 of the Civil Code, the period of the lease contract is deemed to have been set for the benefit of both parties. Renewal of the contract may be had only upon their mutual agreement or at the will of both of them. Since the private respondents were not amenable to a renewal, they cannot be compelled to execute a new contract when the old contract terminated on 1 June 1994. It is the owner-lessor's prerogative to terminate the lease at its expiration." *(Buce vs. Court of Appeals, 332 SCRA 151 [2000].)*

*Note:* In this case, the parties limited the issue to the correct interpretation of the contract. The issue of possession of the leased premises was not among the issues agreed upon by the parties or threshed out before the trial court; neither was it raised by T on appeal. T's right to file an action for the recovery of possession of subject property was recognized.

### Exceptions to the general rule.

The tenor of the obligation or the circumstances may, however, show that it was the intention of the parties to constitute the period for the benefit of either the debtor or the creditor. The benefit of the period may be the subject of express stipulation of the parties.

(1) *Term is for the benefit of the debtor alone.* — He cannot be compelled to pay prematurely, but he can, if he desires, do so.

EXAMPLES:

(1) D borrowed from C P10,000.00 to be paid within one year without interest.

In this case, the period of one year should be deemed intended for the benefit of D only. Therefore, he can pay any time but he cannot be compelled to pay before one year. Although the loan is gratuitous, the terms and conditions of the contract or other circumstances may,

however, indicate that the period has been established for the benefit of both parties.

(2) D promised to pay his debt "on or before December 31, 2004." Here, the payment is to be made within a stipulated period. D can pay before said date. (see Pastor vs. Gaspar, 2 Phil. 592 [1903].)

(3) D promised to pay his debt "for a term of five years counted from this date." It has been held that the debt is payable within five years. (Sia vs. Court of Appeals and Valencia, 92 Phil. 355 [1952].)

(2) *Term is for the benefit of the creditor.* — He may demand fulfillment even before the arrival of the term but the debtor cannot require him to accept payment before the expiration of the stipulated period.

EXAMPLE:

D borrowed from C P10,000.00 payable on December 31 with the stipulation that D cannot make payment before the lapse of the period but C may demand fulfillment even before said date.

Here, C can demand payment at any time but D cannot shorten the one-year period without the consent of C. Ordinarily, there must be a stipulation granting the benefit of the term to only the creditor.

### Acceleration by debtor of time of payment.

The payment of interest may not be the only reason why a creditor may not be bound to receive payment before maturity. There may be other reasons, to wit: "that the creditor may want to keep his money invested safely instead of having it in his hands," and "that the creditor by fixing a period, protects himself against sudden decline in the purchasing power of the currency loaned especially at a time when there are many factors that may influence the fluctuation of the currency."

All available authorities on the matter are agreed that unless the creditor consents, the debtor has no right to accelerate the time of payment even if the premature tender included an offer to pay principal and interest in full. (De Leon vs. Santiago Syjuco, Inc., 90 Phil. 311 [1951].)

Thus, in a case, after holding that the creditor could not be obliged to accept payments before the expiration of the period (5 years) agreed upon, the Supreme Court said: "The creditors evidently stipulated

that repayment could not be made within five (5) years because they wanted to derive some advantage from the change of currency which they foresaw or waited. The creditors wisely provided against repayment in Japanese Notes that were then of little value making the calculation that after five (5) years, the Japanese would not be here and the said notes would have ceased to be lawful currency." (Nicolas vs. Matias, 89 Phil. 126 [1951].)

**Effect of acceptance by creditor of partial payment.**

The acceptance of a partial payment by a creditor amounts to a waiver of the period agreed upon during which payment should not be made. If no explanation is given why the creditor received such partial payment before the maturity of the obligation, it may be presumed that his relinquishment was intentional, and his choice to dispense with the term, voluntary. It is not a mere forbearance. (Lopez vs. Ochoa, 103 Phil. 950 [1958].)

**Computation of term or period.**

(1) The Civil Code provides:

> "When the law speaks of years, months, days or nights, it shall be understood that years are of three hundred sixty-five (365) days each; months of thirty (30) days; days of twenty-four (24) hours; and nights from sunset to sunrise.
>
> If months are designated by their name, they shall be computed by the number of days which they respectively have.
>
> In computing a period, the first day shall be excluded, and the last day included." (Art. 13 thereof.)
>
> If the last day is a Sunday or a legal holiday, the time shall not run until the end of the next day which is neither Sunday nor a holiday.

A year is equivalent to 365 days regardless of whether it is a year or a leap year. (National Marketing Corporation vs. Tecson, 29 SCRA 70 [1969].)

(2) The Administrative Code of 1987 (Exec. Order No. 292.), however, provides:

"Legal Periods — "Year" shall be understood to be twelve calendar months; "month" of thirty days, unless it refers to a specific calendar month in which case it shall be computed according to the number of days the specific month contains; "day," to a day of twenty-four hours; and "night" from sunset to sunrise." (Chap. VIII, Book I, Sec. 31 thereof.)

(3) A *calendar month* is "a month designated in the calendar without regard to the number of days it may contain. "It is the "period of time running from the beginning of a certain numbered day up to, but not including, the corresponding numbered day of the next month, and if there is not a sufficient number of days in the next month, then up to and including the last day of that month."

To illustrate: One calendar month from December 31, 2007 will be from January 1, 2008 to January 31, 2008; one calendar month from January 31, 2008 will be from February 1, 2008 until February 29, 2008.

Under the Administrative Code, a year is composed of 12 calendar months, the number of days being irrelevant, whereas under the Civil Code a year is equivalent to 365 days, whether it be a regular year or a leap year. There exists a manifest incompatibility in the manner of computing legal periods. The Administrative Code of 1987 being the more recent law governs the computation of legal periods. (Comm. of International Revenue vs. Primetown Property Group, Inc., 531 SCRA 436 [2007].)

**ART. 1197. If the obligation does not fix a period, but from its nature and the circumstances it can be inferred that a period was intended, the courts may fix the duration thereof.**

**The courts shall also fix the duration of the period when it depends upon the will of the debtor.**

**In every case, the courts shall determine such period as may under the circumstances have been probably contemplated by the parties. Once fixed by the courts, the period cannot be changed by them. (1128a)**

### Court generally without power to fix a period.

The period mentioned in the above provision refers to a *judicial period* as distinguished from the period fixed by the parties in their contract which is known as *contractual period.*

If the obligation does not state a period and no period is intended, the court is not authorized to fix a period. The courts have no right to make contracts for the parties. (Tolentino vs. Gonzales, 50 Phil. 577 [1927].)

ILLUSTRATIVE CASES:

1. *Authority of court to grant extension where obligation contains no term.*

*Facts:* D, etc., executed a promissory note which reads: "We promise to pay C the sum of P1,352.00 for balance standing against us on this date. Until said amount is paid to C, we engage to pay interest thereon at the rate of 10% *per annum,* as agreed, Jan. 20, 1907. (Sgd.) D, etc." C brought action for recovery of the amount.

*Issue:* There being no period fixed for the payment thereof, is the obligation immediately demandable or should the period first be fixed by the court?

*Held:* It cannot be inferred from the language of the document that it was the intention of C to grant D, etc., any extension of time in the payment, the duration of which should be fixed by judicial authority. Inasmuch as the complaint was filed in court 27 days after the obligation was executed, after payment had been demanded from D, etc., the latter have no right at all to claim an extension for the fulfillment of the obligation, the existence and legality of which they have expressly recognized.

The document contains no term or condition upon which depends the fulfillment of the obligation contracted by D, etc. (see Art. 1179, par. 1.) Therefore, there exists no motive or reason that would exempt them from compliance therewith. (*Floriano vs. Delgado, 11 Phil. 154 [1908];* see Delgado and Figueroa vs. Amenabar, 16 Phil. 403 [1910].)

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2. *Power of court to determine, where the period contemplated is within a reasonable time, if such period had already elapsed or not; applicability of Article 1197.*

*Facts:* S (seller) obligated itself to construct streets around the perimeter of the land sold (site of the Sto. Domingo Church in Quezon City). The parties were aware that the land, on which the streets would be constructed, were occupied by squatters. No definite date was fixed within which the streets would be constructed.

An action for specific performance with damages was brought against S.

*Issues:* (1) Has the court the power under Article 1197 to fix the period for the performance of S's obligation?

(2) If so, when should the obligation be performed?

*Held:* (1) If the issue raised is whether S was given a reasonable time within which to construct the streets, the court should determine whether the parties had agreed that S should have a reasonable time for performance. If the contract so provided, then there was a period fixed, a "reasonable time," and all that the court should do, is to determine if that reasonable time had already elapsed. If it had passed, then the court should declare that S had breached the contract and fix the resulting damages; otherwise, it is bound to dismiss the action for being premature.

Article 1197 is predicated on the absence of any period fixed by the parties (or the fact that period fixed is made to depend on the will of the debtor) but it can be inferred that a period was intended.

(2) As the parties were fully aware that the land was occupied by squatters and must have known that they could not take the law into their own hands, but must resort to legal processes in evicting the squatters, the parties must have intended to defer the performance of the obligation of S until the squatters were duly evicted. *(G. Araneta, Inc. vs. Phil. Sugar Estates Dev. Co., Inc., Ltd., 20 SCRA 330 [1967].)*

### Exceptions to the general rule.

Under Article 1197 (pars 1 and 2), there are two cases when the court is authorized to fix the duration of the period.

Article 1197 is part and parcel of all obligations contemplated therein. Hence, whenever the court fixes the term of an obligation, it does not thereby amend or modify the same. It merely enforces or carries out the intention of the parties. (Deudor vs. J.M. Tuazon and Co., Inc., 2 SCRA 129 [1961].) It cannot arbitrarily fix a period out of thin air for the law expressly prescribes "that the courts shall determine such period as may under the circumstances have been probably contemplated by the parties." (Art. 1197, par. 3.)

### No period is fixed but a period was intended.

If the obligation does not fix a period but it can be inferred from its nature and the circumstances that a period was intended by the parties, the court may fix the period. If the period fixed is extended by agreement, to be valid the same must be for a definite time, although

if no precise date is fixed, it is sufficient that the time can readily be determined. In case the period of extension is not precise, Article 1197 applies. (Pacific Banking Corp. vs. Court of Appeals, 173 SCRA 102 [1989].)

EXAMPLES:

(1) X agreed to construct the house of Y. The parties failed to fix the period within which the construction is to be made. Here, the court can fix the term for it is evident that the parties intended that X should construct the house within a certain period. (see Concepcion vs. People, 74 Phil. 63 [1942].)

(2) B bought lumber from the store of S on credit. The period for payment in the invoice is left blank. From the nature of the obligation, it can be inferred that a period is intended. (see Cosmic Lumber Co., Inc. vs. Manaois, 106 Phil. 1015 [1960]; see Qui vs. Court of Appeals, 66 SCRA 523 [1975].)

In a case, the space for the date on which the installment should have commenced was left blank; *held:* this did not necessarily mean that the debtors were allowed to pay as and when they could, where such intention was not indicated in the promissory note. (see Art. 1180.) On the contrary, the fact that an acceleration clause and a late payment penalty were provided in the promissory note, showed the intention of the parties that the installments should be paid at a definite date. (Radiowealth Finance Co. vs. Del Rosario, 335 SCRA 288 [2000].)

In another case, after finding that Article 1687[3] of the Civil Code was applicable and correlating it with the first paragraph of Article 1197, the Supreme Court said that under both Articles "the court is accorded the power to fix a longer term for the lease, which power is potestative or discretionary in nature, addressed to the court's sound judgment and is controlled by equitable considerations. It may not, therefore, be contended that a court in the exercise of its discretionary power under said articles is making a new contract between the parties,

[3]Art. 1687. If the period for the lease has not been fixed, it is understood to be from year to year, if the rent agreed upon is annual; from month to month, if it is monthly; from week to week, if the rent is weekly; and from day to day, if the rent is to be paid daily. However, even though a monthly rent is paid, and no period for the lessee has been set, the courts may fix a longer term for the lease after the lessee has occupied the premises for over one year. If the rent is weekly, the courts may likewise determine a longer period after the lessee has been in possession for over six months. In case of daily rent, the courts may also fix a longer period after the lessee has stayed in the place for over one month. (1581a)

since the very purpose of the law is not the fixing of a longer term for the lease, but to make the indefinite period of lease definite by fixing once and for all the remaining duration of the lease." (F.S. Divinagracia Agro-Commercial, Inc. vs. Court of Appeals, 104 SCRA 180 [1981].)

ILLUSTRATIVE CASES:

1. *Debt payable in installments without fixing the period for payment.*

*Facts:* D bound himself to pay his debt to C in partial payments as set forth in the promissory note. No fixed day was specified for its fulfillment so that period for payment is undetermined.

*Issue:* May the court fix the term for payment?

*Held:* The obligation being manifestly defective with regard to the duration of the period granted to the debtor, D, that defect must be cured by the courts which shall determine the said duration under the power expressly granted them for such purpose by Article 1197. *(Levy Hermanos vs. Paterno, 18 Phil. 353 [1911].)*

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2. *Donation is subject to a condition for the fulfillment of which no period is fixed.*

*Facts:* R donated to the City of Manila a parcel of land subject to the condition (among others) that "the city should acquire such of the adjoining land as may be necessary to form with mine a public square with gardens and walls." The deed did not fix any period within which the condition should be fulfilled. As many years have elapsed without the city having complied with the condition, R brought action to annul the donation and to recover the property.

*Issue:* Is the action of R proper?

*Held:* No. The contract having fixed no period in which the condition should be fulfilled, the provisions of Article 1197 are applicable and it is the duty of the court to fix a suitable time for its fulfillment.[4] *(Barretto vs. City of Manila, 11 Phil. 624 [1908].)*

[4]In the absence of any just cause for the court to determine the period of compliance, the court may decree the rescission claimed. (see Art. 1191, par. 3.) In *Central Phil. University (CPU) vs. Court of Appeals* (246 SCRA 511 [1995].), CPU (donee) failed for more than 50 years to comply with the condition of the donation to establish a medical college on the land donated. *Held:* "There is no more need to fix the duration of a term of the obligation when such procedure would be a mere technicality and formality and would serve no purpose than to delay or lead to unnecessary and expensive multiplicity of suits."

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3. *The children were invited by the parents, to occupy the latter's two lots but unfortunately, because of an unresolved conflict and out of pique, the parents asked them to vacate the premises.*

*Facts:* Respondents (parents) invited their son and his wife (petitioners) to construct their residence on the subject lots and as the situs of their construction business, in order that they could all live near one other and help in resolving some family problems. Respondents filed with the municipal trial court an ejectment suit against petitioners.

Petitioners dispute the lower courts' finding that they occupied the property on the basis of mere tolerance. They argue that their occupation was not under such condition, since respondents had invited, offered and persuaded them to use said lots.

*Issues:* Is the first paragraph of Article 1197 applicable?

*Held:* No. (1) *Possession was not by mere tolerance.* — The possession of the subject lots by petitioners was not by mere tolerance. It was upon the invitation of and with complete approval of respondents who desired that their children would occupy the premises. It arose from familial love and a desire for family solidarity, which was a basic Filipino trait.

(2) *No period was intended by the parties.* — Petitioners had a right to occupy the lots. The issue is the duration of the possession. In the absence of stipulation, Article 1197 allows the courts to fix the duration or the period. Article 1197, however, applies to a situation in which the parties intended a period. From the facts of the case, no period was intended by the parties. Their mere failure to fix the duration of their agreement does not necessarily justify or authorize the courts to do so.

(3) *Possession was subject to resolutory condition.* — Effectively, there was a resolutory condition in their agreement. When persistent conflict and animosity overtook the love and solidarity between the parents and the children, the purpose of the agreement ceased. Thus, petitioners no longer had any cause for continued possession of the lots. Their right to use the lots ceased upon their receipt of the notice to vacate. *(Macasaet vs. Macasaet, 439 SCRA 625 [2004].)*

### Duration of period depends upon the will of the debtor.

For examples, see comments under Article 1180.

In the two cases provided in Article 1197, the court must fix the duration of the period to forestall the possibility that the obligation may never be fulfilled or to cure a defect in a contract whereby it is

made to depend solely upon the will of one of the parties. In fixing the term, the court is merely enforcing the implied stipulation of the parties. (Deudor vs. J.M. Tuazon and Co., *supra.*) A contract whereby the proceeds of the sale of goods should be turned over to the principal by the agent "as soon [they were] sold" makes the obligation immediately demandable as soon as the goods are disposed of; hence, Article 1197 is not applicable. (Lim vs. People, 133 SCRA 333 [1984].)

ILLUSTRATIVE CASES:

1. *Terms of lease is for so long as lessee pays stipulated rent.*

*Facts:* In the contract of lease, it is provided that R would lease to E a certain building for the sum of P250 beginning on the 1st of March in the year when the agreement was made and to continue "so long as the tenant paid the stipulated rent of P250."

R asked the court to fix a definite term during which the lease should continue.

*Issue:* May the court fix the term of the lease?

*Held:* The court has authority to fix the term of the lease. *(Yu Chin Piao vs. Lim Tuaco, 33 Phil. 92 [1915].)*

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2. *Term of lease contract in case of renewal depends upon will of both lessor and lessee.*

*Facts:* A five-year contract of lease was entered into between R (lessor) and E (lessee). Under the contract, the same "may be renewed after a period of five (5) years under the terms and conditions as will be mutually agreed upon by the parties at the time of renewal."

Notwithstanding the failure of the parties to reach agreement on the terms and conditions of the renewal of the contract, the lower court ordered the renewal on the ground that the lease has never expired because the contract expressly mandated its renewal.

*Issue:* Is the second paragraph of Article 1197 applicable?

*Held:* No. Under the quoted clause, the duration of the renewal period was not left to the will of the lessee alone, but rather to the will of both the lessor and the lessee. Most importantly, Article 1197 applies only where a contract of lease clearly exists. The clause can only mean that R and E may agree to renew the contract upon reaching agreement on the terms and conditions to be embodied in such renewal contract.

This failure to reach such agreement prevented the contract from being renewed at all. Hence, there was in fact no contract at all the period

of which could have been fixed. *(Millare vs. Hernando, 151 SCRA 484 [1987].)*

**Legal effect where suspensive period/ condition depends upon will of debtor.**

(1) The existence of the obligation is not affected although the period depends upon the sole will of the debtor. It is only the performance with respect to time that is left to the will of the debtor.

(2) If the obligation is subject to a condition which depends upon the will of the debtor, the conditional obligation is void (Art. 1182.) because in such case, it is actually the fulfillment of the obligation that depends upon the will of the debtor. (see Art. 1308.)

**Separate action to fix duration of period.**

On obligations coming within the purview of Article 1197, the only action that can be maintained is to ask the court first to determine the term within which the obligor must comply with his obligation for the reason that fulfillment of the obligation itself cannot be demanded until after the court has fixed the period for its compliance and such period has arrived. The duration of the period should be fixed in an action brought for that express purpose separate from the action to enforce payment but such technicality need not be adhered to when a prior and separate action would be a mere formality and would serve no other purpose than to delay. (Concepcion vs. People, 74 Phil. 63 [1942]; Gonzales vs. De Jose, 66 Phil. 369 [1938]; see Tiglao vs. Manila Railroad Co., 98 Phil. 181 [1956]; Calero vs. Carrion, 107 Phil. 549 [1960]; Borromeo vs. Court of Appeals, 47 SCRA 65 [1972]; Pages vs. Basilan Lumber Co., 104 Phil. 882 [1958].)

(1) For instance, where a contract of lease fixes no term but from its nature and the circumstances it may be inferred that the term has been left to the lessee to determine, or when the power to fix the term rests solely with the lessee, the lessor should first bring an action for the purpose of having the court fix its duration and before this is done, an action for eviction under such a contract is premature. (Eleizequi vs. Laron Tennis Club, 2 Phil. 309 [1903]; Yu Chin Piao vs. Lim Tuaco, 33 Phil. 92 [1915]; see Seone vs. Franco, 24 Phil. 309 [1913]; Patente vs. Omega, 93 Phil. 218 [1953].)

(2) Where the contract for the repair of a typewriter did not contain a period for compliance but the parties intended that the defendant was to finish it at some future time, he cannot invoke Article 1197 after he virtually admitted non-performance by returning the typewriter unrepaired. The time for compliance having evidently expired, and there being a breach of contract, it was held academic for the plaintiff to have just petitioned the court to fix a period for performance before filing his complaint. The fixing of a period would thus be a mere formality and would serve no other purpose than to delay. (Chaves vs. Gonzales, 32 SCRA 547 [1970].)

ILLUSTRATIVE CASE:

*No breach or violation is committed before period for fulfillment of obligation is fixed by the court.*

*Facts:* Under the lease contract executed between R (lessor) and E (lessee), upon the expiration of the lease for 20 years, the factory building to be constructed by E shall belong to R. The building constructed by E was destroyed by fire. E could not rebuild the building because the insurance proceeds were not yet paid. R filed a suit for ejectment.

*Issue:* Is the action of R proper?

*Held:* No. His remedy is to institute an action so that the court can fix the period for the reconstruction of the burned building. Only after a competent court shall have fixed such period in a proper action pursuant to the provisions of Article 1197 can there be a breach or violation of the lease contract entered into R's complaint for ejectment is dismissed. *(Qui vs. Court of Appeals, 66 SCRA 523 [1975].)*

### Ultimate facts to be alleged in complaint.

The ultimate facts to be alleged in a complaint to properly and adequately plead the right of action granted by Article 1197 are:

(1) Facts showing that a contract was entered into, imposing on one of the parties an obligation or obligations in favor of another; and

(2) Facts showing or from which an inference may reasonably be drawn, that a period for performance was intended by the parties. (Schenker vs. Gemperle, 5 SCRA 1042 [1962].)

If the complaint does not ask that a period for the performance of an obligation be fixed, the court cannot fix a period unless the

complaint is first amended. (G. Araneta, Inc. vs. Phil. Sugar Estates Dev. Co., Ltd., 20 SCRA 330 [1967].) The court, however, may fix the duration of the period although the complaint does not expressly ask for such relief where the ultimate facts above are sufficiently alleged therein.

**Period fixed cannot be changed by the courts.**

(1) If there is a period agreed upon by the parties and it has already lapsed or expired, the court cannot fix another period. (Gonzales vs. Jose, 66 Phil. 369; Millar vs. Nadres, 74 Phil. 307 [1903]; Millare vs. Hernando, 151 SCRA 484 [1987].)

(2) From the very moment the parties give their acceptance and consent to the period fixed by the court, said period acquires the nature of a covenant, because the effect of such acceptance and consent by the parties is exactly the same as if they had expressly agreed upon it, and having been agreed upon by them, it becomes a law governing their contract. The period fixed in a final judgment is *res judicata* and as such forms an integral part of the imperfect contract which gave rise to its designation by the court, and thence, forward part of a perfect and binding contract. Consequently, the court cannot change it. (Barretto vs. City of Manila, 11 Phil. 624 [1908].) However, the parties may modify the term by a new agreement.

**ART. 1198. The debtor shall lose every right to make use of the period:**

**(1) When after the obligation has been contracted, he becomes insolvent, unless he gives a guaranty or security for the debt;**

**(2) When he does not furnish to the creditor the guaranties or securities which he has promised;**

**(3) When by his own acts he has impaired said guaranties or securities after their establishment, and when through a fortuitous event they disappear, unless he immediately gives new ones equally satisfactory;**

**(4) When the debtor violates any undertaking, in consideration of which the creditor agreed to the period;**

**(5) When the debtor attempts to abscond. (1129a)**

**When obligation can be demanded before lapse of period.**

The general rule is that the obligation is not demandable before the lapse of the period. However, in any of the five (5) cases mentioned in Article 1198, the debtor shall lose every right to make use of the period, that is, the period is disregarded and the obligation becomes pure and, therefore, immediately demandable.

The exceptions are based on the fact that the debtor might not be able to comply with his obligation.

(1) *When debtor becomes insolvent. —*

EXAMPLE:

D owes C P10,000.00 due and payable on December 20. If D becomes insolvent, say on September 10, C, can demand immediate payment from D even before maturity unless D gives sufficient guaranty or security.

The insolvency in this case need not be judicially declared. It is sufficient that the assets of D are less than his liabilities or D is unable to pay his debts as they mature.

Note that the insolvency of D must occur after the obligation has been contracted.

In a case, the statement of the Chairman of the Board of Directors of the mortgagor-corporation that it was "without funds, neither does it expect to have any funds in the foreseeable future" was held a proof of its insolvency. (People's Bank & Trust Co. vs. Dahican Lumber Co., 20 SCRA 84 [1967].)

(2) *When debtor does not furnish guaranties or securities promised. —*

EXAMPLE:

Suppose in the same example, D promised to mortgage his house to secure the debt. If he fails to furnish said security as promised, he shall lose his right to the period. (see Daguhoy Enterprises, Inc. vs. Ponce, 96 Phil. 15 [1954]; Laplana vs. Garchitorena Chereau, 48 Phil. 163 [1925].)

(3) *When guaranties or securities given have been impaired or have disappeared. —*

EXAMPLE:

If the debt is secured by a mortgage on the house of D, but the house

was burned through his fault, the obligation also becomes demandable unless D gives a new security equally satisfactory.

In this case, the house need not be totally destroyed as it is sufficient that the security be impaired by the act of D. But in case of a fortuitous event, it is required that the security must *disappear.* But if the security given deteriorates in such a manner as to become illusory, it must be deemed to have disappeared or lost as contemplated in paragraph 3.

If the debt is secured by a bond, the failure of D to renew the bond or replace it with an equivalent guarantee upon its expiration will likewise give C the right to demand immediate payment. (see Gaite vs. Fonacier, 2 SCRA 831 [1961].)

ILLUSTRATIVE CASE:

*Right of seller to recover whole purchase price of vessel sold on installment basis, which disappeared, while being delivered, due to a fortuitous event.*

*Facts:* S sold to B a launch for P16,000.00 payable in quarterly installments of P1,000.00 each with interest at 10% *per annum.* The launch was shipwrecked and became a total loss while en route to B's place of business. S brought action for the recovery of the whole purchase price.

*Issue:* Is S entitled to the whole purchase price or only for the amount of the unpaid installments due under the express terms of the contract when the complaint was filed?

*Held:* Yes. The security for the payment of the purchase price of the launch itself having disappeared as a result of an unforeseen event and no other security having been substituted therefor, S was clearly entitled to recover judgment not only for the installments of the indebtedness due under the terms of the contract at the time when he instituted the action, but also for all installments which, but for the loss of the vessel, had not matured at that time.[5] *(Song Fo & Co. vs. Oria, 33 Phil. 3 [1915].)*

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[5]Art. 1480. Any injury to or benefit from the thing sold, after the contract has been perfected, from the moment of the perfection of the contract to the time of delivery, shall be governed by Articles 1163 to 1165, and 1262.

This rule shall apply to the sale of fungible things, made independently and for a single price, or without consideration of their weight, number, or measure.

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Art. 1538. In case of loss, deterioration or improvement of the thing before its delivery, the rules in Article 1189 shall be observed, the vendor being considered the debtor.

*Note:* Under Articles 1480 and 1538, if the (specific) thing sold is lost after perfection of the contract of sale but before delivery, that is, even before the ownership is transferred, the buyer bears the risk of loss as an exception to the rule of *res perit domino* (the thing perishes with the owner).

(4) *When debtor violates an undertaking. —*

EXAMPLE:

Now, suppose that C in the example agreed to the period in consideration of the promise of D to repair the piano of C free of charge. The violation of this undertaking by D gives C the right to demand immediate payment of the loan.

(5) *When debtor attempts to abscond. —*

EXAMPLE:

Before the due date of the obligation, D (debtor) changed his address without informing C (creditor) and with the intention of escaping from his obligation. This act of D is a sign of bad faith which results in the loss of his right to the benefit of the period stipulated.

Observe that a mere attempt or intent to abscond is sufficient.

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## SECTION 3. — *Alternative Obligations*

**ART. 1199. A person alternatively bound by different prestations shall completely perform one of them.**

**The creditor cannot be compelled to receive part of one and part of the other undertaking. (1131)**

### Kinds of obligation according to object.

They are:

(1) *Simple obligation.* — one where there is only one prestation, *e.g.*, S obliged himself to deliver to B a piano; S promised to repair the car of B.

(2) *Compound obligation.* — one where there are two or more prestations. It may be.

(a) *Conjunctive obligation.* — one where there are several prestations and all of them are due; or

(b) *Distributive obligation.* — one where one of two or more of the prestations is due. It may be alternative (Art. 1199.) or facultative. (Art. 1206.)

### Meaning of alternative obligation.

An *alternative obligation* is one wherein various prestations are due but the performance of one of them is sufficiently determined by the choice which, as a general rule, belongs to the debtor. (8 Manresa 176; Art. 1200.)

EXAMPLE:

D borrowed from C P10,000. It was agreed that D could comply with his obligation by giving C P10,000, or a color television set, or by painting the house of C.

The delivery of the P10,000, or a color television set, or the painting of the house of C, is sufficient to comply with the obligation. Performance must be complete. C cannot be compelled to accept, for instance, P5,000 and half of the television, thereby establishing a co-ownership between them, or P5,000, and the painting of a part of his house. (Art. 1199, par. 2.)

**ART. 1200. The right of choice belongs to the debtor, unless it has been expressly granted to the creditor.**

**The debtor shall have no right to choose those prestations which are impossible, unlawful or which could not have been the object of the obligation. (1132)**

### Right of choice, as a rule, given to debtor.

As a general rule, the right to choose the prestation belongs to the debtor.

By way of exception, it may be exercised by the creditor but only when *expressly* granted to him (Art. 1205.), or by a third person when the right is given to him by common agreement. (Art. 1306.)

EXAMPLES:

(1) D insured his house with R, an insurance company. It is agreed that, if the house is destroyed or damaged, R may either pay the damage or loss or "reinstate or rebuild the house."

Since nothing is said in the contract as to who has the right of choice, it belongs to R, as debtor.

(2) S binds himself to deliver item one or two to B on November 10 and to communicate his choice on or before November 5.

If S delays in making his selection, B cannot exercise the right because it is not expressly granted to him. But judgment in the alternative cannot be defeated by S by refusing to make a choice. In such case, the court can give the right of choice to B.

ILLUSTRATIVE CASE:

*Obligation is to pay money, but debtor may elect instead to transfer property at a valuation by not paying debt at maturity.*

*Facts:* D, etc. executed in favor of C a document wherein they bound themselves to pay their indebtedness to C, mortgaged their house and lot as security, and agreed to the cession of said house and lot to

C, transferring to her all their rights to the ownership and possession thereof, in case of insolvency on their part. D, etc. paid no part of their indebtedness.

*Issue:* Is the agreement to convey the house and lot at an appraised valuation in the event of failure to pay the debt in money at its maturity valid?

*Held:* Yes. The agreement is simply an undertaking that if the debt is not paid in money, it will be paid in another way. The agreement is not open to the objection that the stipulation is a *pacto commisorio.* (see Art. 2088.) It is not an attempt to permit the creditor to declare a forfeiture of the security upon the failure of the debtors to pay the debt at maturity. It is simply provided that if the debt is not paid in money it be paid in another specific way by the transfer of property at a valuation. The title to the property is not to be transferred to C *ipso facto* upon the failure of C, etc., to pay the debt at its maturity.

The obligations assumed by D, etc., were alternative and they had the right to elect which they would perform. *(Agoncillo and Mariano vs. Javier, 38 Phil. 424 [1918].)*

**Right of choice of debtor not absolute.**

The right of choice of the debtor is subject to limitations. Thus —

(1) The debtor cannot choose those prestations which are: (a) impossible, (b) unlawful, or (c) which could not have been the object of the obligation. These prestations are void. Their presence do not invalidate the obligation if it includes other undertakings otherwise free from such defects. In other words, under Article 1200, the debtor's right of choice is not extinguished altogether but limited to the remaining valid prestations.

(2) The debtor has no more right of choice, when among the prestations whereby he is alternatively bound, only one is practicable. (Art. 1202.) In this case, there is not only a limitation but a loss of the right of choice belonging to the debtor. The obligation becomes simple.

The right does not pass to the creditor, nor may it be exercised by any one.

(3) The debtor cannot choose part of one prestation and part of another prestation. (see Art. 1199, par. 2.)

**ART. 1201. The choice shall produce no effect except from the time it has been communicated. (1133)**

## Communication of notice that choice has been made.

(1) *Effect of notice.* — Until the choice is made and communicated, the obligation remains alternative.

(a) Once the notice of the election has been given to the creditor, the obligation ceases to be alternative and becomes simple.

(b) Such choice once properly made and communicated is irrevocable and cannot, therefore, be renounced. Such rule is inherent in the nature of the choice its purpose being to clarify and render definite the rights of the one exercising the choice, so that the other party may act in consequence. (see Benguet Consolidated Mining Co. vs. Pineda, 98 Phil. 711 [1956]; Reyes vs. Martinez, 55 Phil. 492 [1930].) The concurrence of the creditor to the choice is not required. (see Art. 1200.)

(c) Where the choice has been expressly given to the creditor, such choice shall likewise produce legal effects upon being communicated to the debtor. (Art. 1205, par. 1.)

(2) *Proof and form of notice.* — The burden of proving that such communication has been made is upon him who made the choice. The law does not require any particular form regarding the giving of notice. It may, therefore, be made orally or in writing, expressly or impliedly.

ILLUSTRATIVE CASE:

*Obligation of insurer is to pay the amount of loss, or at its option, replace the property destroyed.*

*Facts:* The house and merchandise of E insured by R (insurance company) were burned while the policy was in force.

The policy contained the following clause: "The Company may at its option reinstate or replace the property damaged or destroyed, or any part thereof, instead of paying the amount of the loss or damage x x x but the company shall not be bound to reinstate exactly or completely, but only as circumstances permit x x x, and in no case shall the company be bound to expend more than it would have cost to reinstate such property as it was at the time of the occurrence of such loss or damage, nor more than the sum insured by the company hereon."

*Issue:* What is the effect of this clause on the obligation of R?

*Held:* Its effect is to make the obligation of R an alternative one, that is to say, that it may either pay the insured value of the house or rebuilt it. In an alternative obligation, the debtor, R in this case, must notify the creditor, E in the instant case, to give him an opportunity to express his consent, or to impugn the election made by the debtor, and only after said notice shall the election take legal effect when consented by the creditor, or if impugned by the latter, when declared proper by the competent court.[1]

In the instant case, the record showed that R did not give a formal notice of its election to rebuild, and while the witnesses spoke of the proposed reconstruction of the house destroyed, yet E did not give his consent to the proposition for the reason that the new house would be smaller and of materials of lower kind than those employed in the construction of the house destroyed. The election alleged by R to rebuild the house burned instead of paying the value of the insurance was improper. *(Ong Guan Can vs. The Century Ins. Co., 46 Phil. 592 [1924].)*

**ART. 1202. The debtor shall lose the right of choice when among the prestations whereby he is alternatively bound, only one is practicable. (1134)**

### Effect when only one prestation is practicable.

If more than one is practicable, it is Article 1200 that will apply. The obligation is still alternative because the debtor still retains the right of choice. Under Article 1202, if only one is practicable (*e.g.*, the others have become impossible), the obligation is converted into a simple one.

**ART. 1203. If through the creditor's acts the debtor cannot make a choice according to the terms of the obligation, the latter may rescind the contract with damages. (n)**

### When debtor may rescind contract.

Rescission creates the obligation to return the things which were the object of the contract together with their fruits, and the price with its interest. (Art. 1385, par. 1.)

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[1]In view of Article 1200, the consent of the creditor is not required.

It is the very nature of an alternative obligation that the debtor can make his choice without the consent of the creditor. Hence, the right given the debtor to rescind the contract and recover damages if, through the creditor's fault, he cannot make a choice according to the terms of the obligation. The debtor, however, is not bound to rescind.

EXAMPLE:

D borrowed from C P20,000.00. It was agreed that instead of P20,000.00, D could deliver item one, or item two, or item three.

If through the fault of C, item one is destroyed, D can rescind the contract if he wants. In case of rescission, the amount of P20,000.00 must be returned by D with interest. C, in turn, must pay D the value of item one plus damages.

D, instead of rescinding the contract, may choose item two or three with a right to recover the value of item one with damages. If D chooses item one, his obligation is extinguished. C is not liable for damages.

**ART. 1204. The creditor shall have a right to indemnity for damages when, through the fault of the debtor, all the things which are alternatively the object of the obligation have been lost, or the compliance of the obligation has become impossible.**

**The indemnity shall be fixed taking as a basis the value of the last thing which disappeared, or that of the service which last became impossible.**

**Damages other than the value of the last thing or service may also be awarded. (1135a)**

## Effect of loss or becoming impossible of objects of obligation.

Articles 1203 and 1204 apply when the right of choice belongs to the debtor. Under Article 1205, the creditor has the right to choose.

(1) *Some of the objects.* — If some of the objects of the obligation have been lost or have become impossible even through the fault of the debtor, the latter is not liable since he has the right of choice and the obligation can still be performed. This is an exception to the general rule established in Article 1170 regarding liability for damages arising from negligence.

(2) *All of the objects.* — If all of them have been lost or have become impossible through the debtor's fault, the creditor shall have a right to indemnity for damages since the obligation can no longer be complied with. Of course, if the cause of the loss is a fortuitous event, the obligation is extinguished.

The phrase "or the compliance of the obligation has become impossible" refers to obligations "to do."

EXAMPLE:

S agreed to deliver item one, or item two, or item three.

If item one is lost through the fault of S, he can still select either item two or item three. The loss of item one and two with or without the fault of S will reduce the obligation to a simple one.

If all the items are lost through his fault, liability will attach; if through a fortuitous event, the obligation will be extinguished.

**Basis of indemnity.**

The indemnity shall be fixed taking as basis the value of the last thing which disappeared (referring to obligations to give) or that of the service which last became impossible (referring to obligations to do). In case of disagreement, it is incumbent upon the creditor to prove such value, or which thing last disappeared or which service last became impossible.

Other damages may also be awarded. (Art. 1204, pars. 2 and 3.)

EXAMPLE:

In the above example, if items one and two are lost, S will be bound to deliver item three.

If subsequently, item three is also lost through the fault of S, the basis for indemnity is the value of item three since S would have been bound to deliver it had it not also been lost. The liability of S is not affected although the loss of items one and two was through a fortuitous event.

If item three is lost without the fault of S, his obligation is extinguished and he shall not be liable for damages although the loss of items one and two was due to his fault. The reason is that after the loss of items one and two, the obligation is converted into a simple one to deliver item three. (Art. 1202.)

S cannot be held responsible for the loss of items one and two

through his fault because having the right of choice, he was not bound to deliver either. The rule is just since he could have been liable for damages if item three instead was lost through his fault and items one and two, through a fortuitous event.

**ART. 1205. When the choice has been expressly given to the creditor, the obligation shall cease to be alternative from the day when the selection has been communicated to the debtor.**

**Until then the responsibility of the debtor shall be governed by the following rules:**

**(1) If one of the things is lost through a fortuitous event, he shall perform the obligation by delivering that which the creditor should choose from among the remainder, or that which remains if only one subsists;**

**(2) If the loss of one of the things occurs through the fault of the debtor, the creditor may claim any of those subsisting, or the price of that which, through the fault of the former, has disappeared, with a right to damages;**

**(3) If all the things are lost through the fault of the debtor, the choice by the creditor shall fall upon the price of any one of them, also with indemnity for damages.**

**The same rules shall be applied to obligations to do or not to do in case one, some or all of the prestations should become impossible. (1136a)**

### Where right of choice belongs to creditor.

In alternative obligations, the right of choice, as a rule, belongs to the debtor. Nevertheless, the debtor may expressly give the right of choice to the creditor. (Art. 1200.) In such a case, the provisions which with respect to the debtor are laid down in the preceding articles, shall be applicable to the creditor when the right of choice is given to him.

Before the creditor makes the selection, the debtor cannot incur in delay.

### Rules in case of loss before creditor has made choice.

(1) *When a thing is lost through a fortuitous event. —*

EXAMPLE:

S obliged himself to deliver to B item one, or item two or item three, or item four. If item one is lost through a fortuitous event, B can choose from among the remainder or that which remains if three of the items are lost.

(2) *When a thing is lost through debtor's fault. —*

EXAMPLE:

If the loss of item one occurs through the fault of S, B may claim item two or item three or item four with a right to damages or the price of item one also with a right to damages.

(3) *When all the things are lost through debtor's fault. —*

EXAMPLE:

If all the items are lost through the fault of S, then B can demand the payment of the price of any one of them with a right to indemnity for damages.

(4) *When all the things are lost through a fortuitous event. —*

EXAMPLE:

The obligation of S shall be extinguished if all the items which are alternatively the object of the obligation are lost through a fortuitous event. In this case, Article 1174 shall apply.

**Rules applicable to personal obligations.**

The above rules are also applicable to personal obligations. (par. 2.) The responsibility of the debtor for damages depends upon whether the cause which has rendered the obligation impossible was due to his fault or not.

**ART. 1206. When only one prestation has been agreed upon, but the obligor may render another in substitution, the obligation is called facultative.**

**The loss or deterioration of the thing intended as a substitute, through the negligence of the obligor, does not render him liable. But once the substitution has been made, the obligor is liable for the loss of the substitute on account of his delay, negligence or fraud. (n)**

### Meaning of facultative obligation.

A *facultative obligation* is one where only one prestation has been agreed upon but the obligor may render another in substitution.

EXAMPLES:

(1) "I will give you my piano but I may give my television set as a substitute."

In this obligation, only the piano is due. Hence, its loss through my fault will make me liable.

(2) "I will mortgage my land to secure my debt which shall be payable within 90 days upon my failure to pay my debt within 30 days."

Here, I may mortgage my land in substitution of the obligation to make payment within 30 days. (see Quizana vs. Redugerio, 94 Phil. 922 [1954].)

### Effect of loss.

(1) *Before substitution*. — If the principal thing is lost through a fortuitous event, the obligation is extinguished; otherwise, the debtor is liable for damages. The loss of the thing intended as a substitute with or without the fault of the debtor does not render him liable.

The reason is that the thing intended as a substitute is not due. The effect of the loss is merely to extinguish the facultative character of the obligation.

EXAMPLE:

S will give B item one or if S wants, item two.

(a) If item one is lost through a fortuitous event, the obligation of S is extinguished. (Arts. 1174, 1262.)

(b) If item one is lost through the fault of S, S is liable for damages. (Art. 1170.)

(c) If item two is lost with or without the fault of S, S is still liable to deliver item one (see Art. 1165.); he is not liable for damage for the loss of item two as it is not due.

(2) *After substitution*. — If the principal thing is lost, the debtor is not liable whatever may be the cause of the loss, because it is no longer due. If the substitute is lost, the liability of the debtor depends upon whether or not the loss is due through his fault.

Once the substitution is made, the obligation is converted into a simple one to deliver or perform the substituted thing or prestation. The substitution becomes effective from the time it has been communicated. (Art. 1201.)

EXAMPLE:

Based on the preceding example:

(a) If item one is lost with or without the fault of S, S is not liable for its loss since his obligation is to deliver item two.

(b) If item two is lost through a fortuitous event, the obligation of S is extinguished.

(c) If item two is lost through the fault of S, S is liable for damages.

**Alternative and facultative obligations distinguished.**

The differences are as follows:

(1) *Number of prestations.* — In the first, several prestations are due but compliance with one is sufficient, while in the second, only one prestation is due although the debtor is allowed to substitute another;

(2) *Right of choice.* — In the first, the right of choice may be given to the creditor or third person, while in the second, the right to make the substitution is given only to the debtor;

(3) *Loss through fortuitous event.* — In the first, the loss of one or more of the alternatives through a fortuitous event does not extinguish the obligation, while in the second, the loss of the thing due extinguishes the obligation;

(4) *Loss through fault of debtor.* — (a) In the first, the loss of one of the alternatives through the fault of the debtor does not render him liable, while in the second, the loss of the thing due through his fault makes him liable; and (b) In the first, where the choice belongs to the creditor, the loss of one alternative through the fault of the debtor gives rise to liability, while in the second, the loss of the substitute before the substitution through the fault of the debtor does not render him liable; and

(5) *Nullity of prestation.* — (a) In the first, the nullity of a prestation does not invalidate the others, while in the second, the nullity of the prestation agreed upon invalidates the obligation; and (b) in the first, the debtor or creditor shall choose from among the remainder, while in the second, the debtor is not bound to choose the substitute.

The second paragraph of Article 1206 speaks of "thing." Nevertheless, the provision applies to both real and personal obligations. The word is employed in its broad sense to mean the same as prestation in the first paragraph. (see Art. 1223.)

**Alternative obligations and alternative remedies distinguished.**

In ordinary alternative obligations, a mere choice categorically and unequivocally made and then communicated by the person entitled to exercise the option concludes the parties. The creditor may not thereafter exercise any other option, unless the chosen alternative proves to be ineffectual or unavailing due to no fault on his part. This rule, in essence, is the difference between alternative obligations, on the one hand, and alternative remedies, upon the other hand, where, in the latter case, the choice generally becomes conclusive only upon the exercise of the remedy.

For instance, in one of the remedies expressed in Article 1484[2] of the Civil Code, it is only when there has been a foreclosure of the chattel mortgage that the vendee-mortgagor would be permitted to escape from a deficiency liability. Thus, if the case is one for specific performance, even when this action is selected after the vendee has refused to surrender the mortgaged property to permit an extrajudicial foreclosure, that property may still be levied on execution and an *alias* writ may be issued if the proceeds thereof are insufficient to satisfy the judgment credit. So, also, a mere demand to surrender the object which is not heeded by the mortgagor will not amount to a foreclosure, but the repossession thereof by the vendor-mortgagee would have the effect of foreclosure. (Borbon II vs. Servicewide Specialists, Inc., 258 SCRA 634 [1996].)

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[2]Art. 1484. In a contract of sale of personal property the price of which is payable in installments, the vendor may exercise any of the following remedies:

(1) Exact fulfillment of the obligation, should the vendee fail to pay;

(2) Cancel the sale, should the vendee's failure to pay cover two or more installments;

(3) Foreclose the chattel mortgage on the thing sold, if one has been constituted, should the vendee's failure to pay cover two or more installments. In this case, he shall have no further action against the purchaser to recover any unpaid balance of the price. Any agreement to the contrary shall be void. (1454-A-a)

## SECTION 4. — *Joint and Solidary Obligations*

**ART. 1207. The concurrence of two or more creditors or of two or more debtors in one and the same obligation does not imply that each one of the former has a right to demand, or that each one of the latter is bound to render, entire compliance with the prestations. There is a solidary liability only when the obligation expressly so states, or when the law or the nature of the obligation requires solidarity. (1137a)**

**ART. 1208. If from the law, or the nature or the wording of the obligations to which the preceding article refers the contrary does not appear, the credit or debt shall be presumed to be divided into as many equal shares as there are creditors or debtors, the credits or debts being considered distinct from one another, subject to the Rules of Court governing the multiplicity of suits. (1138a)**

### Kinds of obligation according to the number of parties.

They are:

(1) *Individual obligation.* — one where there is only one obligor and one obligee; and

(2) *Collective obligation.* — one where there are two or more debtors and/or two or more creditors. It may be joint or solidary.

In a collective obligation, there are two relations involved: that between the creditor and the debtors (or the creditors and the debtor, or the creditors and the debtors) and that among the creditors and/or debtors themselves.

**Meaning of joint and solidary obligations.**

(1) A *joint obligation* is one where the whole obligation is to be paid or fulfilled proportionately by the different debtors and/or is to be demanded proportionately by the different creditors. (Art. 1208.)

(2) A *solidary obligation* is one where each one of the debtors is bound to render, and/or each one of the creditors has a right to demand entire compliance with the prestation. (Art. 1207.)

**Collective obligation presumed to be joint.**

(1) If A is liable to B for P9,000.00, there can be no problem regarding the determination of the following:

(a) the person liable to pay;

(b) the person entitled to demand payment;

(c) the extent of the liability of the debtor; and

(d) the extent of the right of the creditor.

(2) Where there is a plurality of parties (two or more debtors and/or two or more creditors) and *the share of each in the obligation is specified*, the correlative rights and obligations of the parties are known.

Thus, if A, B, and C are liable to D in the amount of P9,000, and it is stated that the corresponding share of each debtor is P3,000.00 (it may be in unequal amounts), we know that A, B, and C are liable only for P3,000.00 each and that D is not entitled to collect from each debtor more than his corresponding share in the obligation.

(3) On the other hand, let us suppose that in the same obligation, the share of each debtor (or the share of each creditor, if there are two or more creditors) is not specified. What is the extent of the liability of A, B, and C? In such case, the presumption is that the obligation is joint (Arts. 1207-1208.), and as a consequence:

(a) There are as many debts as there are debtors;

(b) There are as many credits as there are creditors;

(c) The debts and/or credits are considered distinct and separate from one another;

(d) Each debtor is liable only for a proportionate part of the debt; and

(e) Each creditor is entitled only to a proportionate part of the credit.

The presumption established in Article 1208 is rebuttable.

EXAMPLES:

(1) A, B, and C borrowed P9,000.00 from D. The presumption is that A, B, and C are jointly liable.

Here, there are three (3) debts and one (1) credit. D can demand only P3,000.00 each from A, B, and C or a total of P9,000.00.

Since the debts are distinct and separate from each other, the insolvency of one of the debtors shall not make the others liable.

(2) A borrowed from B, C, and D P9,000.00. Unless the contrary appears, the obligation is *prima facie* a joint one.

In this case, there is one (1) debt and three (3) credits. Each creditor can demand only P3,000.00 from A.

(3) A and B are liable to C and D for P9,000.00. The same presumption applies. There are two (2) debts and two (2) credits.

Each creditor can demand only P4,500.00 from either debtor. Of course, the total liability of A or B, and the total collection of C or D, cannot exceed P4,500.00.

ILLUSTRATIVE CASE:

*Final judgment against several defendants does not specify that their liability is solidary.*

*Facts:* Under a contract, the obligation of A, B and C was solidary. However, the judgment rendered against them, which has become final, was for the total amount sued without stating the nature or extent of their liability.

*Issue:* May judgment be executed on the property of C alone to satisfy the entire obligation.

*Held:* No. Each of the defendants is liable only for his proportionate part of the judgment which superseded the action for the enforcement of the contract. A court has no power to amend a judgment that has become final. *(Oriental Commercial vs. Cebato, 60 Phil. 723 [1934].)*

### Presumption subject to rules on multiplicity of suits.

The presumption in Article 1208 is made "subject to the Rules of Court governing the multiplicity of suits" (Art. 1208.); otherwise,

situations may arise where there are as many suits as there are debtors and creditors. (see Rules of Court, Rule 3, Sec. 6.)

**Words used to indicate joint liability.**

Other words used for joint obligations are: *mancum, mancomunada*; *mancomunadamente; pro rata;* proportionately; *pro rata*, jointly; *conjoint;* "we promise to pay" signed by two or more persons.[1] (see Jaucian vs. Querol, 38 Phil. 707 [1918]; Parol vs. Gemora, 7 Phil. 94 [1906]; see Lafarge Cement Phils., Inc. vs. Continental Cement Corp., 443 SCRA 522 [2004].)

It has been held that an admission of two debtors in their brief that their liability in the contract is a solidary one does not convert the joint character of their obligation as appearing in their contract for what determines the nature of the obligation is the tenor of their contract itself, not the admission of the parties. (Un Fak Leang vs. Negurra, 9 Phil. 381 [1907]; Tiu vs. Court of Appeals, 228 SCRA 51 [1993].)

**Characteristics, essence, and basis of a solidary obligation.**

(1) Every solidary obligation has these characteristics: unity of object and plurality of ties. The prestation due, or to which a right exists, is one and the same thing.

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[1] "In Spanish law, the comprehensive and generic term by which to indicate multiplicity of obligations arising from plurality of debtors or creditors, is *mancomunidad*, which term includes (1) *mancomunidad simple* or *mancomunidad* properly such and (2) *mancomunidad solidaria.* In other words, the Spanish system recognizes two species of multiple obligation, namely, the apportionable joint obligation and the solidary joint obligation. The solidary obligation is, therefore, merely a form of joint obligation. The idea of the benefit of division as a feature of the simple joint obligation appears to be a peculiar creation of Spanish jurisprudence. No such idea prevailed in the Roman Law, and it is not recognized either in the French or in the Italian system.

In the common law system, every debtor in a joint obligation is liable *in solidum* for the whole; and the only legal peculiarity worthy of remark concerning the joint contract at common law is that the creditor is required to sue all the debtors at once. To avoid the inconvenience of this procedural requirement and to permit the creditor in a joint contract to do what the creditor in a solidary obligation can do under Article 1144 (now Art. 1216.) of the Civil Code, it is not unusual for the parties to a common law contract to stipulate that the debtors shall be jointly and severally liable. The force of this expression is to enable the creditor to sue any one of the debtors or all together at pleasure." (Jaucian vs. Querol, 38 Phil. 718-719 [1918].) So, the sense of the English word "joint," as used in the common law, is to be understood in the sense of "solidary" in our jurisdiction, but subject to the procedural requirement mentioned in the absence of stipulation that the debtors shall be, for example, "jointly and severally liable."

(2) The essence of solidarity is that each and every one of the solidary creditors can demand and each of the debtors must satisfy the same prestation, with the resulting duty on the part of the creditor who received payment to pay to each of his co-creditors what belongs to him, and the resulting right on the part of the debtor who made payment to claim from his co-debtors the share which corresponds to each. (Art. 1217.)

(3) The basis of solidarity in either case has something of a legal fiction, *i.e.,* that it is a mutual agency (see 4 Sanchez Roman 50.) among those interested in the same obligation.

The solidary obligation is really a form of joint obligation. (see Note 1.)

**When obligation solidary.**

Solidary liability is not lightly inferred. Under Article 1207, there is solidary liability only when:

(1) the obligation expressly so states; or

(2) the law requires solidarity; or

(3) the nature of the obligation requires solidarity.

Solidary liability also exists when it is imposed in a final judgment against several defendants.

**Words used to indicate solidary liability.**

It is not necessary that the agreement should employ precisely the word "solidary" in order that an obligation may be so considered. It is sufficient that the obligation declares, for instance, that each one of the debtors can be compelled to pay the entire obligation, or can be proceeded against for the full amount of the obligation, or that demand may be made against any one of them, etc. (see 8 Manresa 191; Juan Ysmael & Co. vs. Salinas, 75 Phil. 601 [1946]; see Art. 1216.)

Examples of other words used to indicate solidarity are: severally, jointly and/or severally; *solidaria; in solidum;* solidarily; together and/or separately; individually and/or collectively; *juntos o suparadamente.* "I promise to pay" signed by two or more persons. It has been held that the words "individually and jointly" create a solidary liabil-

ity. (Ronquillo vs. Court of Appeals,[2] 132 SCRA 274 [1984].) Solidary obligations may be used interchangeably with "joint and several" or "several." Usage of the term "joint and solidary" is confusing and ambiguous. (Lafarge Cement Phils., Inc. vs. Continental Cement Corp., 443 SCRA 522 [2004].)

In a case, the petitioners claimed that they signed the letters of credit and related documents pertaining to the transactions with a bank. The documents show that the petitioners agreed to jointly and severally undertake payment of the obligation and also consented to each and all of the stipulated condition on the document; *held:* "An experienced businessman who signs important legal papers cannot disclaim the consequent liabilities therefor after being a signatory thereon." (Blade International Marketing Corporation vs. Court of Appeals, 372 SCRA 333 [2001].)

**Kinds of solidarity.**

They are:

(1) *According to the parties bound:*

(a) *Passive solidarity* or solidarity on the part of the debtors, where anyone of them can be made liable for the fulfillment of the entire obligation. Its characteristics are plurality of debtors and unity of prestation. It is in the nature of a mutual guaranty.

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[2]In this case, the Supreme Court (citing Words and Phrases, Perm. Ed., Vol. 21, p. 194 and Vol. 39, p. 72.) said that the term "individually" has the same meaning as "collectively," "separately," "distinctly," "respectively," or "severally." An agreement to be "individually liable" undoubtedly creates a several obligation, and a "several obligation" is one by which an individual binds himself to perform the whole obligation.

It is submitted, however, that in our jurisdiction, a contract which uses the word "individually," "separately," "distinctly," or "respectively," in an obligation where there is a plurality of debtors, must be taken to have in contemplation, as it does, a joint obligation apportionable among the debtors. The idea of the benefit of division is totally foreign to the common law system. It is, therefore, easy to see why in the common law the use of any of said words is nevertheless construed as conveying the sense of a solidary obligation so far as the extent of the debtors' liability is concerned. Indeed, the word "joint" in the common law expresses the meaning of "solidary" in our jurisdiction. It is only to avoid the inconvenience of the procedural requirement of suing all the debtors at once that the parties to a common law contract use a compound expression such as "individually and jointly" or "jointly and severally" and similar expressions "to enable the creditor to sue any one of the debtors or all together at pleasure." (see Jaucian vs. Querol, *supra.*)

EXAMPLES:

(1) A and B are solidary debtors of C in the amount of P10,000.00.

There is here only one (1) debt, the debt of A and B in the amount of P10,000.00; and one (1) credit, the credit of C in the amount of P10,000.00 against B and C. (A distinction must be made between the debt itself and the persons against whom the debt can be collected.)

C may demand payment from either A or B, or both of them simultaneously, the whole obligation. (Art. 1216.) Payment by A (or B) extinguishes the obligation but A (or B) may claim from B (or A) the share which corresponds to him depending upon the agreement between them. (Art. 1217.)

In any case, C cannot collect more than P10,000.00 which is the extent of his credit.

(2) Under their contract, either A *or* B will pay C P10,000.00. Here, the debtors are named disjunctively or in the alternative. Their liability is solidary and C can demand payment from either of them unless it clearly appears that the intention of the parties is that either A or B may pay without right of choice on the part of C.

(b) *Active solidarity* or solidarity on the part of the creditors, where anyone of them can demand the fulfillment of the entire obligation. Its essential feature is that of mutual representation among the solidary creditors with powers to exercise the rights of others in the same manner as their rights. (see 8 Manresa 205-206.)

EXAMPLES:

(1) A is liable for P10,000.00 in favor of B and C who are solidary creditors.

A may pay either B or C. (Art. 1214.) So long as the entire debt is not paid, B and C can demand payment from A. (Art. 1207.) If B (or C) received payment, he is liable to C (or B) for the latter's share in the credit according to their agreement.

The liability of A cannot exceed P10,000.00 which is the extent of his liability.

(2) The obligation of A is to pay P10,000.00 to either B *or* C.

In this case, either B or C may demand payment from A unless it clearly appears that the intention of the parties is to give to A the right to choose whom to pay.

(c) *Mixed solidarity* or solidarity on the part of the debtors and creditors, where each one of the debtors is liable to render, and each one of the creditors has a right to demand, entire compliance with the obligation.

EXAMPLE:

A and B are solidarily liable to C and D, solidary creditors, in the amount of P10,000.00.

A (or B) can pay either C or D. C (or D) can demand from either A or B. The payment by A (or B) of P10,000.00 to C (or D) shall extinguish the obligation. A (or B) can ask reimbursement from B (or A) in the amount of P5,000.00 or such amount agreed upon between them. C (or D), in turn, is liable to give to D (or C), the latter's share of P5,000.00 or the amount stipulated.

Remember that the agreement between A and B, as to the extent of the share of each in the debt, or C and D, as to the extent of the share of each in the credit, has nothing to do with the agreement between A and B, on the one hand, and C and D, on the other.

(2) *According to source:*

(a) *Conventional solidarity* or where solidarity is agreed upon by the parties. (Art. 1306.) If nothing is mentioned in the contract relating to solidarity, the obligation is only joint.

(b) *Legal solidarity* or where solidarity is imposed by the law.

EXAMPLES:

(1) If two or more heirs take possession of the estate, they shall be solidarily liable for the loss or destruction of a thing devised or bequeathed, even though only one of them should have been negligent. (Art. 927.)

(2) Even when the agent has exceeded his authority, the principal is solidarily liable with the agent if the former allowed the latter to act as though he had full powers. (Art. 911.)

(3) All partners are solidarily liable with the partnership for any crime or quasi-delict committed by any partner acting in the ordinary course of business of the partnership or with the authority of his co-partners. (Arts. 1822-1824.)

(4) If two or more persons have appointed an agent for a common transaction or undertaking, they shall be solidarily liable to the agent for all the consequences of the agency. (Art. 1915.)

(5) When there are two or more bailees to whom a thing is loaned in the same contract, they are liable solidarily. (Art. 1945.)

(6) The responsibility of two or more officious managers shall be solidary, unless the management was assumed to save the thing or business from imminent danger. (Art. 2146, 2nd par.)

(7) The responsibility of two or more payees, when there has been a payment of what is not due, is solidary. (Art. 2157.)

(8) The responsibility of two or more persons who are liable for a quasi-delict is solidary. (Art. 2194.)

(9) The liability of spouses whose property relations during the marriage are governed by the regime of separation of property are solidary. (Arts. 143, 146, Family Code.)

(10) If the engineer or architect supervises the construction of a building, he shall be solidarily liable with the contractor for damages for any defect in the construction. (Art. 1723; see Nakpil & Sons vs. Court of Appeals, 144 SCRA 796 [1980].)

(11) In a felony, the principal, accomplices, and accessories, each within their respective class, shall be liable severally *(in solidum)* among themselves for their quotas, and subsidiarily for those of other persons liable. (Art. 110, Revised Penal Code.)

(12) The provisions of existing laws to the contrary notwithstanding, every employer or indirect employer (*i.e.,* any person, partnership, association or corporation which, not being an employer, contracts with an independent contractor for the performance or any work, task, job or project) shall be held responsible with his contractor or subcontractor for any violation of any provision of the Labor Code. (see Arts. 106, 107, 109, Labor Code; Rosewood Processing, Inc. vs. National Labor Relations Commission, 290 SCRA 408 [1998].) The solidary liability of the one who paid does not preclude the application of the Civil Code provision (*i.e.,* Art. 1217.) on his right of reimbursement from his co-debtor. (Mariveles Shipyard Corp. vs. Court of Appeals, 415 SCRA 573 [2003].)

(c) *Real solidarity* or where solidarity is imposed by the nature of the obligation.

The law does not expressly indicate the cases where the liability is solidary because of the nature of the obligation. The opinion is offered that the cases contemplated are those in which the intent or purpose of the law is to have the obligation satisfied in full but the law itself does not expressly require solidarity.

Thus, the nature of the obligation of employers under the former Workmen's Compensation Law[3] (Sec. 2, Rep. Act No. 4119; see Arts. 1711, 1712.), to pay indemnity or compensation or death or injury caused to their employees while in the performance of their assigned duty, was held solidary although the law is silent on this point because the law was enacted to give full protection to employees, and if the responsibility were only joint, the purpose of the law might not be attained should one of the employers happen to be insolvent. (Liwanag vs. Workmen's Compensation Commission, 105 Phil. 741 [1959].)

Similarly, where the vehicle which figured in an accident was operated under the so-called "*kabit* system," the award of exemplary damages, among others, payable jointly and severally by the operator and the grantee of the certificate of public convenience was held justified because the pernicious "*kabit* system" is a violation of law. (Canares vs. Aras, CA-G.R. No. 2488-R, March 4, 1961.)

ILLUSTRATIVE CASE:

*Requirement for application of rules concerning joint and solidary obligations.*

*Facts:* It appears that A, lessee of a lot, is the owner of a building under receivership; that the rentals on the building collected by B, receiver, belong to A; that B is a mere custodian of the funds thus collected and held by him; that the judgment in favor of C, lessor, against B, ordering him to pay the rentals in question jointly and severally with A, merely enforces an obligation of A, to whom said funds belong, and that the liability of B under the said judgment is nothing but the very same liability of A.

B raised the propriety of his inclusion as defendant with A in the action by C for the recovery of unpaid rentals on the lot. He argued that he was not a party to the contract of lease, and neither the same, nor the nature of the contract, nor the law, made him solidarily liable with A for the rentals.

*Issue:* Are the rules concerning joint obligations and solidary obligations applicable?

[3]Now embodied in Articles 166-208, Title II, Labor Code (Pres. Decree No. 442, as amended.), which provide a tax-exempt employees' compensation program administered by the Employees' Compensation Commission.

*Held:* No. Said rules require a plurality of subjects (creditors, debtors, or both) and have no application when there is only one creditor and one debtor, even if payment of the debt is to be made by several individuals representing one and the same interest or debtor. The argument of B is predicated upon the wrong theory that he, as receiver, represents an interest completely distinct and separate from that of A. *(Abella vs. G.K. Co., Bun Kim and Q. Carpio, 100 Phil. 1019 [1957].)*

**Passive solidarity and solidary guaranty compared.**

Article 2047, paragraph 2 (Title XV. — Guaranty.) says:

"If a person binds himself solidarily with the principal debtor, the provisions of Section 4, Chapter 3, Title 1 of this Book shall be observed. In such case, the contract is called a suretyship."

(1) *Similarities.* — They are:

(a) In passive solidarity although some sort of mutual agency may be seen as in active solidarity, guaranty is a characteristic which predominates over that of mere agency. By virtue of this, the solidary debtor like the surety, answers for a debt which is not properly his own; and

(b) Like the surety also, after paying, he may demand reimbursement from the debtor personally bound in the obligation paid.

(2) *Distinctions.* — While a guarantor may bind himself solidarily with the principal debtor, the liability of a guarantor is different from that of a solidary debtor. (Inciong, Jr. vs. Court of Appeals, 257 SCRA [1996].) The distinctions are as follows:

(a) The solidary debtor, unlike the surety, is liable, not only for the debt of another but also for one properly his own. (8 Manresa 219.) A (guarantor or) surety does not incur liability unless the principal debtor is held liable. It is in this sense that a surety, although solidarily liable with the principal debtor, is different from the debtor. It does not mean that the surety cannot be held liable to the same extent as the principal debtor. The nature and extent of the liabilities of a surety is determined by the contract of suretyship (Pacific Banking Corp. vs. Intermediate Appellate Court, 203 SCRA 496 [1991].);

(b) In passive solidarity, the debtor who made payment may claim reimbursement from his co-debtors for the share which corresponds to each (Art. 1217, par. 2.), while in a suretyship, the surety who paid the obligation is entitled to be indemnified by the principal debtor with the right to be subrogated by virtue of such payment to all the rights which the creditor had against the debtor (Arts. 2066, 2067.); and

(c) In passive solidarity, an extension granted by the creditor to one of the solidary debtors without the consent of the other solidary debtors would not release the latter from their obligations. They are still liable for the whole obligation less the share of the debtor granted the extension. Upon arrival of the extended period, the creditor can demand the remaining balance from any of the solidary creditors but in suretyship, an extension granted to the principal debtor without the consent of the surety would have the effect of extinguishing the suretyship. (see Art. 2079.)

**Solidarity not presumed.**

The presumption, where there are two or more persons in the same obligation, is that it is joint. The reason is that solidary obligations are very burdensome for they create unusual rights and liabilities. Solidarity between debtors increases their responsibility while solidarity between creditors increases the right of each creditor. The law tends to favor the debtors in presuming that they are bound jointly and not solidarily.

(1) Where a person authorizes another to mortgage and borrow money for and in his name, the liability of the two to the creditor is only joint, not solidary, pursuant to Articles 1207 and 1208. (Phil. National Bank vs. Sta. Maria, 29 SCRA 30 [1969].)

(2) When it is not provided in a judgment that the defendants are liable to pay jointly and severally a certain sum of money, none of them may be compelled to satisfy in full said judgment. It is of no consequence that the obligation assumed by them under their written contract was solidary in character. The final judgment has the effect of superseding the action brought for enforcement of said contract. (Ang Lin Chi vs. Castelo, 63 Phil. 263 [1936]; Oriental Commercial Co., Inc. vs. Abeto and Mabanag, 60 Phil. 723 [1934]; De Leon vs. Nepomuceno, 37 Phil. 180 [1917]; Ortiz vs. Kayanan, 92 SCRA 146 [1979]; Industrial

Management International Development Corp. vs. National Labor Relations Commission, 331 SCRA 640 [2000].)

(3) One of the effects of the rule established by the Code that the debt is to be presumed as "divided into as many equal shares . . . as there are debtors" (Art. 1208.) is that "the interruption of prescription by the claim of a creditor addressed to a single debtor or by an acknowledgment made by one of the debtors in favor of one or more of the creditors is not to be understood as prejudicial to or in favor of the other debtors or creditors." (8 Manresa 182; Agoncillo and Marino vs. Javier, 38 Phil. 424 [1918].)

**ART. 1209. If the division is impossible, the right of the creditors may be prejudiced only by their collective acts, and the debt can be enforced only by proceeding against all the debtors. If one of the latter should be insolvent, the others shall not be liable for his share. (1139)**

## Joint indivisible obligation.

This article speaks of a joint indivisible obligation. The obligation is joint because the parties are merely proportionately liable. It is indivisible because the object or subject matter is not physically divisible into different parts. (see Art. 1225, par. 1.) In other words, it is joint as to liabilities of the debtors or rights of the creditors but indivisible as to compliance. (see Art. 1224.)

This obligation constitutes the middle ground between a joint obligation and a solidary obligation.

EXAMPLES:

(1) A, B, and C are jointly liable to give D a car valued at P240,000.00. On the date of delivery, A and B are willing to deliver but C is not.

In this case, D has no cause of action against C for the delivery of the car because, as a joint-debtor, C is liable only for a proportionate part of the obligation which is P80,000.00. Since the object (car) is indivisible, the debt can only be enforced by proceeding against all the debtors for compliance is not possible unless they act together.

Pursuant to Article 1224 *(infra.),* the liability is converted into one for damages. So, A, B, and C will be liable for P80,000.00 each or a total of P240,000.00 which is the value of the car without increase of responsibility for A and B. C, the unwilling debtor, shall be liable for damages to D for having violated the obligation.

If A and B suffered damages by reason of the non-fulfillment by C, they may recover them from C.

Should anyone of the debtors be insolvent, the others shall not be liable for their share. (Art. 1209.) D must wait until the insolvent debtor can pay.

(2) If there are two creditors, say D and E, and one debtor, A, the obligation can be performed only by delivering the car to them jointly. A (there may be more than one debtor) can insist that both D and E together accept the car; and if either of them refuses to join the other, A may legally refuse to deliver the car. He may deposit the car in court by way of consignation. (see Art. 1256.)

If A becomes liable to pay damages for non-performance, D and E can recover only their respective shares in the indemnity. Neither D nor E may do anything which may be prejudicial to the other (Art. 1212.) like renouncing or assigning the entire obligation without the consent of the other. This is so because the obligation is joint, *i.e.,* the credit of D is separate from that of E, and, therefore, neither D nor E can act in representation of the other. Their rights may be prejudiced only by their collective acts. (Art. 1209.)

**ART. 1210. The indivisibility of an obligation does not necessarily give rise to solidarity. Nor does solidarity of itself imply indivisibility. (n)**

## Indivisibility distinguished from solidarity.

The differences are:

(1) Indivisibility refers to the prestation, while solidarity refers to the juridical or legal tie that binds the parties;

(2) In indivisible obligations, only the debtor guilty of breach of obligation is liable for damages (Arts. 1209, 1224.), thereby terminating the agency, while in solidary obligations, all of the debtors are liable for the breach of the obligation committed by a co-debtor (Art. 1221.), for solidarity among them remains;

(3) Indivisibility can exist although there is only one debtor and one creditor, while in solidarity, there must be at least two debtors or two creditors (Arts. 1207, 1208.); and

(4) In indivisible obligations, the others are not liable in case of insolvency of one debtor, while in solidary obligations, the others are proportionately liable. (Art. 1217.)

The first sentence of Article 1210 simply means that the liability in an indivisible obligation may be either joint or solidary. The second sentence means that in a solidary obligation, the subject matter may be divisible or indivisible. (see Art. 1225.)

EXAMPLES:

(1) A and B are jointly liable to deliver to C a particular car. Here, the prestation is indivisible but the liability of A and B is joint. We have what is called a *joint indivisible obligation.* (Arts. 1209, 1224.)

(2) If A and B obliged themselves solidarily to give the car to C, we have a *solidary indivisible obligation* — the obligation is indivisible and the liability of A and B is solidary.

To put it in another way, we have a solidary obligation the subject matter of which is indivisible. In case of breach, even the innocent debtors are liable for the entire indemnity without prejudice to their right of action against the guilty one. (Art. 1221, par. 2.)

(3) A solidary obligation does not necessarily mean that the obligation is also indivisible. Thus, where A and B promised *in solidum* to pay C P10,000.00, we have an example of a *solidary divisible obligation.*

(4) Now, if A and B are jointly liable to pay C P10,000.00, what we have is a *joint divisible obligation*. Money is divisible.

**ART. 1211. Solidarity may exist although the creditors and the debtors may not be bound in the same manner and by the same periods and conditions. (1140)**

### Kinds of solidary obligation according to the legal tie.

They are:

(1) *Uniform.* — when the parties are bound by the same stipulations or clauses; or

(2) *Non-uniform or varied.* — when the parties are not subject to the same stipulations or clauses. (see 4 Sanchez Roman 50.)

### Solidarity not affected by diverse stipulations.

The essence of solidarity consists in the right of each creditor to enforce the rights of all and the liability of each debtor to answer for the liabilities of all. Therefore, there may be a solidary obligation

although the parties may not be bound in the same manner and by the same periods and conditions. The rule is that the creditor may bring his action *in toto* against any of the solidary debtors less the shares of the other debtors with unexpired terms or unfulfilled conditions who are entitled to defenses under Article 1222.

Upon the expiration of the term or the fulfillment of the condition, the creditor will have the right to demand the payment of the remainder. (Inchausti & Co. vs. Yulo, 34 Phil. 978 [1916]; see 8 Manresa 203; Operators Incorporated vs. American Biscuit Co., Inc., 154 SCRA 738 [1987].)

The parties may stipulate that any solidary debtor already bound may be made liable for the entire obligation.

EXAMPLE:

A, B, C, and D obliged themselves solidarily to pay E P20,000.00, as follows:

A, to pay by installment at the rate of P1,000.00 a month, to start in July; B, to pay in September; C, to pay in December; and D, if E passes the Bar examinations.

(a) In July, E can demand only P1,000.00 from A. E can also make a demand from B, C, and/or D the P1,000.00 share corresponding to A. But E cannot recover yet the shares of B, C, and D which are not yet due and demandable.

(b) In September, E is entitled to collect from any of the solidary debtors the share corresponding to B which is P5,000.00 and A, P1,000.00 or P3,000.00, if A had not yet paid any installment. The shares of C and D are not yet recoverable.

(c) In December, E can recover from any of the solidary debtors, the share corresponding to C in the amount of P5,000.00 plus such amounts from the shares of A and B which have not yet been paid. The share of D will mature only after E passes the Bar examinations.

(d) If E passes the Bar examinations, the obligation of D to pay P5,000.00 arises. This amount can be demanded from any of the solidary debtors. Again, E is also entitled to recover all amounts which are already due and demandable and unpaid pertaining to the shares of A, B, and C.

(e) If the agreement is that E may demand the *entire* obligation from B in September, from C in December, or from D if E passes the Bar

examinations, then B is liable for P20,000.00 in September less the amount, if any, already paid by A and D; C is liable for P20,000.00 in December less the amount, if any, already paid by A, B, and D. D is liable for P20,000.00 if E passes the Bar examinations less the amount, if any, already paid by A, B, and C.

**Joint obligation on one side, solidary on the other.**

An obligation may be joint on the side of the creditors and solidary on the side of the debtors, or *vice versa.*

In such cases, the rules applicable to each subject of the obligation should be applied, the character of the creditors or the debtors determining their respective rights and liabilities. Thus, if the obligation is joint on the side of the creditors, and solidary on the side of the debtors, each creditor can demand only his share in the obligation; but each debtor may be compelled to pay the entire obligation to the creditors. (8 Manresa 201-202.)

EXAMPLES:

(1) A and B, joint debtors, are liable to C and D, solidary creditors, for P1,000.00. Here, we have two (2) separate debts of A and B (P500.00 each), and one (1) credit (P1,000.00) of C and D. C *or* D can demand from A *and* B P500.00 each only, their respective share in the debt; and A and B may be required to pay P500.00 each, either to C or to D.

In other words, A and B are not liable for more than P500.00 each and C or D is entitled to receive not more than P1,000.00.

(2) Assume that A and B are the solidary debtors, and C and D, the joint creditors. Now we have one (1) debt (P1,000.00) of A and B, and two (2) separate credits (P500.00 each) of C *and* D. C and D can demand P500.00 each, their respective share in the credit, from A or B; and A or B may be compelled to pay P1,000.00 (the entire obligation), P500.00 to C and P500.00 to D.

In other words, A or B may be made liable for P1,000.00 and C and B are entitled to receive not more than P500.00 each.

**ART. 1212. Each one of the solidary creditors may do whatever may be useful to the others, but not anything which may be prejudicial to the latter. (1141a)**

### Act of solidary creditor useful/ prejudicial to others.

A solidary creditor may do any act beneficial or useful to the others but he cannot perform any act prejudicial to them. If he performs such act and as a result the obligation is extinguished, he shall be responsible to the others for damages. As far as the debtor or debtors are concerned, the act shall be valid and binding.

The rule is based on the theory of mutual agency among the solidary creditors. A joint creditor cannot act in representation of the others.

EXAMPLE:

A owes B and C, solidary creditors, the sum of P2,000.00. B may make a demand for the payment of the obligation for this will benefit C. Under the law, the prescription of action is interrupted when they are filed before the court. (Art. 1155.) So also, if B collects from A, C will be benefited.

In case of remission or condonation effected by B, the obligation will be extinguished but since C cannot be prejudiced by the remission, B has to reimburse C for the latter's share. (Art. 1215.)

**ART. 1213. A solidary creditor cannot assign his rights without the consent of the others. (n)**

### Assignment by solidary creditor of his rights.

In the absence of consent given by the others, a solidary creditor cannot assign his rights to a third person. The reason behind this prohibition is that each creditor represents the others and the assignee may not have the confidence of the original solidary creditors considering that the assignee after receiving payment may not give the shares of the others. (see Art. 1178.)

If the assignment is made to a co-creditor, the consent of the other creditors is not necessary.

### Effect of unauthorized assignment.

Suppose a solidary creditor did assign his rights, will payment to the assignee extinguish the obligation? Article 1213 seems to imply that such assignment is invalid. This article has been criticized as follows:

"This rule is unjustifiable and places an unnecessary restriction on the rights of the solidary co-creditor upon his share. The reason behind it seems to be that each creditor represents the others and, therefore, must have the confidence of the latter. But in the first place, confidence between co-creditors cannot properly be said to exist except in the case of a solidary credit by contract.

In the second place, the representation (by each creditor) of the solidary creditors is created by law and not by consent or agreement of the parties. If danger is seen in the possible misfeasance of the assignee, the remedy is not the paralyzation of the proprietary rights of the solidary creditor, but to impose upon him a subsidiary responsibility for the acts of the assignee, similar to that of the agent for the acts of the sub-agent under Art. 1892.[4]

This is Manresa's view in his comment to Art. 1141 of the Code of 1889. So that Art. 1213 could have been made to read: 'A solidary creditor who assigns his rights without the consent of his co-creditors shall answer subsidiarily for any prejudice caused to the latter by the assignee in connection with the credit.' " (Justice J.B.L. Reyes, Observation on the New Civil Code, XVI L.J. 48, Jan. 31, 1951.)

**ART. 1214. The debtor may pay any one of the solidary creditors; but if any demand, judicial or extrajudicial, has been made by one of them, payment should be made to him. (1142a)**

## Payment to any of the solidary creditors.

The rule is that the debtor may pay any one of the solidary creditors. But when a demand, judicial or extra-judicial, has been made by one of them, to avoid confusion, as well as prejudice to the more diligent creditor, payment should be made to him; otherwise, the obligation will not be extinguished except insofar as the creditor-payee's share is concerned in case the latter does not give to the other creditors their

[4]Art. 1892. The agent may appoint a substitute if the principal has not prohibited him from doing so; but he shall be responsible for the acts of the substitute:

(1) When he was not given the power to appoint one;

(2) When he was given such power, but without designating the person, and the person appointed was notoriously incompetent or insolvent.

All acts of the substitute appointed against the prohibition of the principal shall be void. (1721)

shares in the payment. The demand has the effect of terminating the mutual agency among the solidary creditors.

Article 1214 is applicable not only in cases of active solidarity but also where the solidarity is mixed although the singular "debtor" is employed. In case of mixed solidarity, the debtor upon whom no demand has been made, may pay any one of the solidary creditors.

**ART. 1215. Novation, compensation, confusion or remission of the debt, made by any of the solidary creditors or with any of the solidary debtors, shall extinguish the obligation, without prejudice to the provisions of Article 1219.**

**The creditor who may have executed any of these acts, as well as he who collects the debt, shall be liable to the others for the share in the obligation corresponding to them. (1143)**

### Liability of solidary creditor in case of novation, compensation, confusion, or remission.

Novation, compensation, confusion, and remission are modes or causes of extinguishment of obligations. (Art. 1231.) It is but logical that the creditor who executed any of these acts should be liable to the others for their corresponding shares considering that such acts are prejudicial to them. (Art. 1212.)

The different causes of extinguishment of an obligation are discussed under Chapter 4, Articles 1231-1304.

### Effect of extension of time given by creditor to a solidary debtor.

An extension of time granted by the creditor to a solidary debtor does not amount to a novation that will discharge the other solidary debtors. The latter shall be liable for the whole debt less the share of the debtor granted the extension. (see Art. 1211.) Upon the expiration of the term, the creditor can demand payment of the unpaid share from any of the solidary debtors.

In suretyship, the effect of the extension given to the principal debtor without the consent of the surety is to extinguish the contract of suretyship. (Art. 2079.)

*Note:* In a suretyship, a person (surety) binds himself solidarily with the principal debtor. (see Art. 2047, par. 2.) In a solidary obligation, a

solidary debtor is himself a principal debtor. Hence, a solidary debtor cannot be considered a guarantor of his co-debtor.

**Effect of novation, etc. where obligation joint.**

In a joint obligation, novation, compensation, confusion, remission, prescription, and any other cause of modification or extinction does not extinguish or modify the obligation except with respect to the creditor or debtor affected, without extending its operation to any other part of the debt or of the credit. (1 Giorgi on Obligations 83; Agoncillo and Mariano vs. Javier, 38 Phil. 424 [1918].)

**ART. 1216. The creditor may proceed against any one of the solidary debtors or some or all of them simultaneously. The demand made against one of them shall not be an obstacle to those which may subsequently be directed against the others, so long as the debt has not been fully collected. (1144a)**

**Right of creditor to proceed against any solidary debtor.**

The above provision is not applicable to a joint obligation. (Lino Luna vs. Arcenas, 34 Phil. 80 [1915].) It reiterates the rule that in a solidary obligation (passive solidarity), any one or some or all of the solidary debtors simultaneously, may be made to pay the debt so long as it has not been fully collected.

(1) Since the liability is solidary, the other, solidary debtors are not indispensable parties in a suit filed by the creditor. (De Castro vs. Court of Appeals, 384 SCRA 607 [2002].)

(2) The bringing of an action against a solidary debtor to enforce the payment of the obligation is not inconsistent with and does not preclude the bringing of another to compel the others to fulfill their obligations. (see Phil. National Bank vs. Confessor and Diaz, [CA] 37 O.G. 2395.) A solidary debtor is also a surety. (see Art. 2047.)

(3) In case of death of one of the solidary debtors, the creditor may proceed against the estate of the deceased solidary debtor alone or against any or all of the surviving solidary debtors whose liability is independent of and separate from the deceased debtor, instead of instituting a proceeding for the settlement of the estate of the deceased debtor wherein his claim could be filed. (Imperial Insurance, Inc. vs. David, 133 SCRA 317 [1984].)

(4) The choice is left to the solidary creditor to determine against whom he will enforce collection. (Phil. National Bank vs. Independent Planters Assoc., Inc., 122 SCRA 113 [1983]; Dimayuga vs. Phil. Commercial and Industrial Bank, 200 SCRA 143 [1991].)

The rule in Article 1216 may be modified by agreement of the parties.

ILLUSTRATIVE CASE:

*The court dismissed a collection suit upon the death of one of the solidary debtors, holding that the claim should be pursued against the estate of the deceased.*

*Facts:* Before the collection suit filed by B (bank), creditor, against the joint and solidary debtors could be decided, A, one of the debtors dies.

After having been informed of the death, the court issued an order dismissing the case, citing Section 6, Rule 86 of the Rules of Court which provides: "*Solidary obligation of decedent.* — Where the obligation of the decedent is solidary with another debtor, the claim shall be filed against the decedent as if he were the only debtor, without prejudice to the right of the estate to recover contribution from the other debtor. In a joint obligation of the decedent, the claim shall be confined to the portion belonging to him."

*Issue:* Is the dismissal of the case correct?

*Held:* No. A cursory perusal of the cited provision reveals that nothing therein prevents a solidary creditor from proceeding against the surviving solidary debtors. Said provision merely sets up the procedure in enforcing collection in case a creditor chooses to pursue his claim against the estate of the deceased solidary debtor.

To require the solidary creditor to proceed against the estate, making it a condition precedent for any collection action against the surviving debtor to prosper, would deprive him of his substantative rights provided by Article 1216, "to proceed against any one of the solidary debtors or some or all of them simultaneously." The choice is undoubtedly left to the solidary creditor. *(Phil. National Bank vs. Asuncion, 80 SCRA 321 [1977].)*

**ART. 1217. Payment made by one of the solidary debtors extinguishes the obligation. If two or more solidary debtors offer to pay, the creditor may choose which offer to accept.**

**He who made the payment may claim from his co-debtors only the share which corresponds to each, with the interest for**

**the payment already made. If the payment is made before the debt is due, no interest for the intervening period may be demanded.**

**When one of the solidary debtors cannot, because of his insolvency, reimburse his share to the debtor paying the obligation, such share shall be borne by all his co-debtors, in proportion to the debt of each. (1145a)**

### Effects of payment by a solidary debtor.

Article 1217 refers to the effects of payment by one of the solidary debtors. It is not applicable where no such payment has been made. (Republic vs. Angeles, 20 SCRA 628 [1967].)

(1) *Between the solidary debtors and creditor(s).* — Payment made by one of the solidary debtors extinguishes the obligation. (When speaking of payment that extinguishes an obligation, the law refers to payment in full.) However, the creditor for his protection is given the right to choose which offer to accept if two or more solidary debtors offer to pay. (par. 1.)

(2) *Among the solidary debtors.* — Payment by one of the solidary debtors does not create a real case of subrogation. (see Arts. 1302, 1303.) It merely entitles him to claim *reimbursement* from his co-debtors "only the share which corresponds to each." (see Art. 1277.), *i.e.,* only for their proportionate shares with (legal) interest only from the time of payment.

(a) The other debtors do not become by virtue of such payment solidary debtors of the debtor-payer. Their liability is not based on the original obligation which has been extinguished, but upon the payment made by the co-debtor which creates a joint obligation of reimbursement on the part of the others. (Art. 1208.) However, in case of insolvency of any of the solidary debtors, the others assume the share of the insolvent one *pro rata.* (pars. 2 and 3.)

(b) Payment by a solidary debtor does not automatically result in a corresponding obligation of the other debtors to reimburse the paying debtor. If a solidary debtor pays the obligation in part, he can recover reimbursement from the co-debtors only in so far as his payment exceeded his share in the obligation.

(c) If the amount is equal to his proportionate share in the obligation he, in effect, pays only what is due from him; if the

amount is less than his share, he cannot demand reimbursement because his payment is less than his actual debt. (see Republlic Glass Corporation vs. Qua, 435 SCRA 480 [2004].)

(3) *Among the solidary creditors.* — The receiving creditor is jointly liable to the others for their corresponding shares. (Art. 1208.)

EXAMPLES:

(1) A, B, and C are jointly and severally liable to D and E in the amount of P3,000.00 due on January 5.

If both A and B offer to pay D, on January 5, the latter may choose which offer to accept. If A pays the entire amount of P3,000.00 on January 5, the obligation is extinguished.

(2) The payment by A gives him the right to demand reimbursement from B and C P1,000.00 each with interest from the date of payment. But A is not entitled to reimbursement nor to interest for any payment made before January 5. The obligation of B and C to reimburse him with interest will arise only from January 5.

If C is insolvent, both A and B shall bear his insolvency in proportion to their shares. Hence, A can still ask B to pay an additional sum of P500.00. Of course, A and B can later on recover from C should the latter's finances improve.

If, in the same example, A paid only P2,400.00 and B, P600.00, A can recover reimbursement only to the extent that his payment exceeds his share, so that C is liable to him for P1,000.00 and B, for P400.00. If C is insolvent, B is liable to pay A P900.00. A is not entitled to reimbursement if his payment is P1,000 or less.

(3) D, in the above example, has the obligation to give to E his corresponding share in the credit.

ILLUSTRATIVE CASES:

1. *A solidary debtor who paid the entire debt contends that the obligation of the co-debtor to pay him his share arose on the date the original debt was created and not on the date he made the payment.*

*Facts:* In 1938 (before the second world war), A, B, and C jointly and severally signed a promissory note in the amount of P90,000.00 in favor of D bank. Upon demand of E bank, as liquidator of all enemy banks, among which was D bank, B paid the promissory note with interest on November 1944.

After liberation, B demanded payment from A and C of their corresponding shares. C paid but A refused to pay his 1/3 share or

P37,530.40 demanded by B on the ground that he should pay only P625.51 which is the equivalent value as of November 1944 of P37,530.40 in Japanese military notes paid by B to D bank, under the Ballantyne schedule. (see Art. 1249.)

B contended that the obligation of A to pay B was created not on the date he made payment to E but on the date of the original obligation, *i.e.*, before the war, and, therefore, the Ballantyne schedule was not applicable.

*Issue:* Did the payment made by B subrogate him in the rights of D bank, transmitting to him the credit with all the rights appertaining thereto?

*Held:* No. When B paid the entire loan, the whole obligation was extinguished and a new obligation was created in favor of B against A and C on his having paid the entire loan. The obligation in favor of B to pay him what he paid in favor of A was created in November 1944 and not before. In other words, the payment by B did not create a real case of subrogation. B did not step into the shoes of D bank. D could collect the whole amount of the loan from anyone of the solidary co-debtors and in fact did from one of them. This, B could not do.

According to Article 1217, payment by one of the solidary debtors entitles him to claim from his co-debtors only the share pertaining to each with interest on the amount advanced, and this is what B was doing, only that he wanted to collect the whole amount paid by him in genuine Philippine currency instead of the equivalent thereof under the Ballantyne schedule.

Moreover, on grounds of equity, B should not be allowed to collect from A more than the real value of what he paid for him especially when the difference between the military notes and the genuine Philippine currency in November 1944 was so great. (*Wilson vs. Berkenkotter, 92 Phil. 918 [1955];* see Phil. International Surety Co., Inc. vs. Gonzales, 3 SCRA 391 [1961].)

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2. *Insurer against third party liability was held by the court solidarily liable to third party, with the insured and the other parties found at fault.*

*Facts:* M Co., insurance company, issued an insurance policy in favor of X covering a jeep. The coverage was "for own damage" not to exceed P600.00 and "third party liability" in the amount of P20,000.00. During the effectivity of the policy, the jeep while being driven by Y, an employee of Z, collided with a passenger bus causing injuries to W.

The Court of Appeals ruled that M Co. was solidarily liable with X and Z and it was not entitled to be reimbursed by Z for whatever amount M Co. was adjudged to pay X.

*Issue:* Is the above ruling correct?

*Held:* No. The liability of M Co. to Z is based on the contract of insurance[5] with X; that of X and Z is based on tort.[6] If M Co. were solidarily liable with X and Z by reason of the indemnity contract against third party liability — under which an insurer can be directly sued by a third party — this will result in violation of the principles underlying solidary obligation and insurance contracts.

In the case at bar, M Co., X and Z were held solidarily liable to W for a total amount of P29,103.00 with the qualification that M's liability is only up to P20,000.00. In the context of a solidary obligation, M may be compelled by W to pay the entire obligation, notwithstanding the qualification made by the trial court. But under the third party liability policy, M's liability is limited only to pay P20,000.00. Moreover, the qualification, when the obligation to P29,103.00 is made solidary, is an evident breach of the concept of a solidary obligation.

Subrogation is normal incident of a indemnity insurance even without any express stipulation to that effect in the policy. Accordingly, only X and Z are solidarily liable to W. If X is made to pay the entire obligation of P29,103.00 and M, as insurer of X, is compelled to pay P20,000.00 of said obligation, M, under Article 1217 would be entitled as subrogee of X as against Z to be reimbursed 1/2 of P29,103.00. *(Malayan Insurance Co., Inc. vs. Court of Appeals, 165 SCRA 536 [1988].)*

**ART. 1218. Payment by a solidary debtor shall not entitle him to reimbursement from his co-debtors if such payment is made after the obligation has prescribed or become illegal. (n)**

## Effect of payment where obligation has already prescribed or become illegal.

When a solidary debtor pays the obligation, he is entitled, as a rule, to reimbursement from his co-debtors. Article 1218 mentions two cases when the paying debtor cannot get any reimbursement. When the obligation has prescribed (Art. 1231, par. 2; see Art. 1424.) or

[5]A contract of insurance is an agreement whereby one undertakes for a consideration to indemnify another against loss, damage or liability arising from an unknown or contingent event. (Pres. Decree No. 1460, Sec. 2.)

[6]See Article 1162.

become illegal (Art. 1266.), the obligation is extinguished. Hence, there is no more obligation to be complied with.

**Prescriptive periods of actions.**

"By *prescription*, one acquires ownership and other rights through the lapse of time in the manner and under the conditions laid down by law.

In the same way, rights and actions are lost by prescription." (Art. 1106.)

"The following actions must be brought within ten (10) years from the time the right of action accrues:

(1) Upon a written contract;

(2) Upon an obligation created by law;

(3) Upon a judgment." (Art. 1144.)

"The following actions must be commenced within six (6) years:

(1) Upon an oral contract;

(2) Upon a quasi-contract." (Art. 1145.)

"The following actions must be instituted within four (4) years:

(1) Upon an injury to the rights of the plaintiff;

(2) Upon a quasi-delict." (Art. 1146.)

The statute of limitations, however, may be superseded or modified by a contract between the parties. (Macias & Co. vs. China Fire Insurance Co., 46 Phil. 345 [1924].)

**ART. 1219. The remission made by the creditor of the share which affects one of the solidary debtors does not release the latter from his responsibility towards the co-debtors, in case the debt had been totally paid by anyone of them before the remission was effected. (1146a)**

**Effect of remission of share after payment.**

If payment is made first, the remission (see Art. 1270.) or waiver is of no effect. There is no more obligation to remit. If remission is made previous to the payment and payment is made, *solutio indebiti* arises. It is incumbent upon the debtor whose debt is remitted, to

prove the priority of the remission to the payment to release him from responsibility towards his co-debtors.

The purpose of the article is to forestall fraud whereby the debt having been paid, the creditor, who does not stand to suffer any loss or damage, remits the share of a particular debtor. The article also secures equality and justice to the paying debtor inasmuch as the payment benefits his co-debtors.

EXAMPLES:

(1) A and B are liable *in solidum* to C in the amount of P1,000.00. C remitted A's share. Subsequent payment by B of P1,000.00 to C will not entitle him to reimbursement from A since the remission extinguished the obligation with respect to A's share. However, B can demand the return of P500.00 from C under the principle of *solutio indebiti.*

If payment by B was made before the remission, A is still liable to B because the remission is without effect, the obligation having been extinguished already by the payment.

(2) A, B, and C are liable *in solidum* to D in the amount of P3,000.00. D remitted the share of A. After paying D P2,000.00, the balance of the credit, B demands reimbursement from C who became insolvent after the remission.

Is A obliged to contribute to the share of C? Yes. Article 1217 (par. 3.), says that the share of the insolvent co-debtor "shall be borne by *all* his co-debtors, in proportion to the debt of each." Furthermore, the remission can only refer to the share of A in the obligation and cannot, therefore, affect his responsibility to contribute to the share of C, the insolvent debtor. A creditor has no right to alter or modify the rights and obligations of the solidary debtors as among themselves.

**ART. 1220. The remission of the whole obligation, obtained by one of the solidary debtors, does not entitle him to reimbursement from his co-debtors. (n)**

## No right to reimbursement in case of remission.

The reason for the above article is that the debtor who obtains remission pays nothing to the creditor. Remission is essentially gratuitous. It is really a donation. (Art. 1270.) Observe that the article applies only when the whole obligation is remitted.

In case of novation, compensation, or confusion (see Art. 1215.), the debtor with whom it is effected is entitled to recover from his co-debtors their corresponding shares of the obligation.

**ART. 1221. If the thing has been lost or if the prestation has become impossible without the fault of the solidary debtors, the obligation shall be extinguished.**

**If there was fault on the part of any one of them, all shall be responsible to the creditor, for the price and the payment of damages and interest, without prejudice to their action against the guilty or negligent debtor.**

**If through a fortuitous event, the thing is lost or the performance has become impossible after one of the solidary debtors has incurred in delay through the judicial or extra-judicial demand upon him by the creditor, the provisions of the preceding paragraph shall apply. (1147a)**

## Rules in case thing has been lost or prestation has become impossible.

If the thing is lost or the prestation becomes impossible, the liability of the solidary debtors depends upon whether or not there is fault or delay.

(1) *Loss is without fault and before delay.*

EXAMPLE:

A, B, and C obliged themselves solidarily to deliver to D a particular truck valued at P300,000.00.

The obligation shall be extinguished if the truck is lost or destroyed through a fortuitous event without the fault of A, B, and C and before they have incurred in delay. (Arts. 1262, par. 1; 1174.)

(2) *Loss is due to fault on the part of a solidary debtor.*

EXAMPLES:

(a) If, in the preceding example, the truck was lost through the fault of C, A and B shall also be responsible to D for the price of the truck as well as damages although A and B were not at fault at all. A solidary obligation is, in essence, a mutual agency. As far as the creditor is concerned, the fault or delay of one solidary debtor, shall be the fault or delay of all the solidary debtors.

A and B, however, can recover from C, the guilty or negligent debtor, the full amount of such price and damages if A and B have already contributed to the price of the truck. (par. 2; Art. 1170.)

If D recovers the price and damages from C, the latter cannot claim reimbursement from A and B, because he alone was at fault.

(b) Suppose now that the truck in question belonged to C and A and B would contribute P100,000.00 each as their share in the obligation. If B paid D P300,000.00 plus P10,000.00 as damages, B can recover the shares of A and C (P100,000.00 each) in the price of the truck. Only C shall bear the damages of P10,000.00. In this case, the loss of C would be P410,000.00: P100,000.00 for his share, P10,000.00 for the damages, and P300,000.00, the value of his truck.

In the first example (a) where A and B have already given their shares in the price of the truck, assuming that P310,000.00 also was paid by B to D, the loss of C would also be P410,000.00: P310,000.00, the amount paid which he is under obligation to reimburse, and P100,000.00, his share in the price of his truck. Note that C may also be made liable to pay interest for the payment made.

(3) *Loss is without fault but after delay.*

EXAMPLE:

If the truck was lost through a fortuitous event but after a demand was made upon C, D can still recover damages from A or B or both of them without prejudice to the right of action of the latter against C following the same rule in No. 2.

The default by C makes all of the solidary debtors responsible even for a fortuitous event. (par. 3; Art. 1170.)

**ART. 1222. A solidary debtor may, in actions filed by the creditor, avail himself of all defenses which are derived from the nature of the obligation and of those which are personal to him, or pertain to his own share. With respect to those which personally belong to the others, he may avail himself thereof only as regards that part of the debt for which the latter are responsible. (1148a)**

## Defenses available to a solidary debtor.

In actions filed by the creditor, a solidary debtor may avail himself of the following defenses:

(1) *Defenses derived from the nature of the obligation.*

EXAMPLE:

A and B are solidarily liable to C in the amount of P10,000.00. The entire debt of A and B was paid by D. In an action by C against A, the latter can raise the defense of payment by virtue of which the obligation was extinguished.

A defense derived from the nature of the obligation is a *complete defense* because it nullifies the obligation or renders it ineffective. Other examples are fraud, prescription, remission, illegality or absence of consideration, *res judicata*,[7] non-performance of a suspensive condition, etc.

(2) *Defenses personal to, or which pertain to share of, debtor sued.* — A solidary debtor, by his own act or inaction, such as by failing to appeal, may lose the benefit of the provisions of Article 1222. (Quano Arrastre Service, Inc. vs. Aleonar, 202 SCRA 618 [1991].)

EXAMPLES:

(a) If the action by C is against B, and B was insane at the time the obligation was contracted, B can put up the defense of insanity with respect to the *entire* obligation. This defense is personal to B alone. It is a complete defense.

Other examples are: incapacity, mistake, violence, minority, etc.

(b) Assume now that the portion of the obligation affecting B is subject to a suspensive condition which has not yet happened.

In this case, the non-fulfillment of the condition is a *partial defense* as it can be set up by B only with respect to his share. C can demand from B the portion of the obligation pertaining to A because B is solidarily liable.

(3) *Defenses personal to other solidary debtors.*

EXAMPLE:

In the two preceding examples, the defense of insanity or non-fulfillment of the suspensive condition is not available to A as to release him from his liability for his share in the obligation.

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[7]When the obligation of the other solidary debtors is so dependent on that of their co-solidary debtor, the release of the one who appealed, provided, it be not grounds personal to such appealing debtor, operates as well as to the others who did not appeal. The decision or judgment in favor of the debtor who appealed can be invoked as *res judicata* by the other debtors who did not join in the appeal. (Universal Motors Corp. vs. Court of Appeals, 205 SCRA 448 [1992].)

In other words, A may avail himself thereof only as regards that part of the debt for which B is liable. Hence, having only a partial defense, A is still liable for P2,000.00, his share in the obligation. (see Braganza vs. Villa Abrille, 105 Phil. 456 [1959].)

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## SECTION 5. — *Divisible and Indivisible Obligations*

**ART. 1223. The divisibility or indivisibility of the things that are the object of obligations in which there is only one debtor and only one creditor does not alter or modify the provisions of Chapter 2 of this Title. (1149)**

### Meaning of divisible and indivisible obligations.

(1) A *divisible obligation* is one the object of which, in its delivery or performance, is capable of partial fulfillment.

(2) An *indivisible obligation* is one the object of which, in its delivery or performance, is not capable of partial fulfillment.

### Test for the distinction.

In determining whether an obligation is divisible or not, the controlling circumstance is not the possibility or impossibility of partial prestation but the purpose of the obligation or the intention of the parties. Hence, even though the object or service may be physically divisible, an obligation is indivisible if so provided by law or intended by the parties. (Art. 1225, par. 3.)

However, if the object is not physically divisible or the service is not susceptible of partial performance (Art. 1225, par. 1.), the obligation is always indivisible, the intention of the parties to the contrary notwithstanding. This rule is absolute.

An obligation is presumed indivisible where there is only one creditor and only one debtor. (see Art. 1248.)

### Applicability of Article 1223.

While Article 1223 appears to be limited to *real* obligations because it speaks of "things," the word is used in its broad sense as referring to

the *object* or *prestation* of the obligation, which may be to deliver a thing or to render some service.

EXAMPLES:

(1) D agreed to pay C P2,000.00 in four equal monthly installments. The obligation of D is divisible because it is capable of partial performance.

But if the agreement is that D will pay C on a certain date the full amount of P2,000.00, the obligation is indivisible although money is physically divisible because the intention of the parties is that the obligation must be fulfilled at *one time and as a whole* (not partially).

The divisibility of an obligation should not, therefore, be confused with the divisibility of the thing which is the object thereof.

(2) S obliged himself to deliver to B a specific car on November 15. This obligation is indivisible because it is not capable of partial performance. The car must be delivered at *one time and as a whole.*

(3) Suppose the agreement is that S will deliver one-half of the car on November 15 and the other half on November 30. Of course, it would be inconceivable that B would agree to a partial performance of the obligation, but let us just assume he did. Will the obligation be divisible or indivisible?

The obligation is still indivisible and S must deliver the whole car on November 15 or November 30. A definite thing like a car, cannot be severed into parts without altering its essence or destroying its value. It is an essential condition of the fitness of a thing to be divisible that it is possible, by uniting the diverse portions thereof, to reconstruct it as if existed before its division. (4 Sanchez Roman 93.)

ILLUSTRATIVE CASE:

*Contract contemplates stage-by-stage construction and payment approach.*

*Facts:* One of the conditions of the building contract is that C (contractor) shall start the construction of the building by stages advancing the necessary amount needed for each stage of work and O (owner), to reimburse the amount spent on the work accomplished by C before proceeding to the next stage, and that C will give a *new* performance bond in proportion to the remaining value or cost of the unfinished work as per approved plans and specifications.

*Issue:* Does the amount of the bond (20%) refer to the whole unfinished work?

*Held:* No. The parties contemplate a divisible obligation necessitating a performance "in proportion to" the uncompleted work. The quoted words mean a bond equal to 20% of the next stage of work to be done. It would have been different were C is required to give a new performance bond *to cover* the remaining value cost of the unfinished work of the construction. (*Pasay City Government vs. CFI of Manila, 132 SCRA 156 [1987];* see Gonzales vs. Court of Appeals, 124 SCRA 630 [1983].)

**Kinds of division.**

They are:

(1) *Qualitative division* or one based on quality, not on number or quantity of the things that are the object of the obligation.

EXAMPLE:

A and B are heirs of C. They agreed to divide the inheritance as follows: to A — a house and lot and home appliances and to B — a ricefield, a car and P100,000.00 cash.

(2) *Quantitative division* or one based on quantity rather than on quality.

EXAMPLE:

In the preceding example, if the inheritance consists only of a ricefield its partition by metes and bounds into two equal parts is a quantitative division. Another example, is when A and B divide 300 cavans of palay harvested from the ricefield or the P100,000.00 cash.

(3) *Ideal* or *intellectual division* or one which exists only in the minds of the parties.

EXAMPLE:

Suppose the car and the ricefield in the first example, were inherited by both A and B.

As co-owners, their one-half shares in the car are not separable in a material way but only mentally. Similarly, before the land is actually divided between A and B, they are merely co-owners, and neither one of them can say that he is the absolute owner of a specific portion thereof.

**Kinds of indivisibility.**

They are:

(1) *Legal indivisibility.* — where a specific provision of law declares as indivisible, obligations which, by their nature, are divisible (Art. 1225, par. 3.);

(2) *Conventional indivisibility.* — where the will of the parties makes as indivisible, obligations which, by their nature, are divisible *(Ibid.);* and

(3) *Natural indivisibility.* — where the nature of the object or prestation does not admit of division, *e.g.,* to give a particular car, to sing a song, etc. (*Ibid.,* par. 1.)

**Where there is only one creditor and one debtor.**

The provisions of Chapter 2, Title 1, regarding the "Nature and Effect of Obligations" in general (Arts. 1163 to 1178.) are also applicable to divisible or indivisible obligations. They contemplate obligations involving only one creditor and only one debtor.

Since divisibility or indivisibility refers to the object or prestation (see Art. 1210.), it does not alter or modify said provisions. (Art. 1223.) When there is only one creditor and one debtor, the latter has to perform the obligation in its totality, whether or not the prestation is divisible. Unless there is an express stipulation to that effect, says Article 1248 (par. 1.), the creditor cannot be compelled partially to receive the prestations in which the obligation consists; and in accordance with Article 1232, an obligation is not deemed paid unless the thing or service in which the obligation consists has been completely delivered or rendered, as the case may be.

**ART. 1224. A joint indivisible obligation gives rise to indemnity for damages from the time anyone of the debtors does not comply with his undertaking. The debtors who may have been ready to fulfill their promises shall not contribute to the indemnity beyond the corresponding portion of the price of the thing or of the value of the service in which the obligation consists. (1150)**

### Effect of non-compliance by a debtor in a joint indivisible obligation.

If any one of the debtors does not comply with his undertaking in a joint indivisible obligation, the obligation is transformed into one for damages, *i.e.,* to pay money. The creditor cannot ask for specific performance or rescission because there is no cause of action against the other debtors who are willing to fulfill their promises.

In a solidary obligation, the breach by a co-debtor makes all debtors liable for damages. The obligation remains solidary without prejudice to their right against the guilty or negligent debtor. (Art. 1221, par. 2.) In a joint indivisible obligation, the effect of non-compliance by a debtor is to make all the debtors liable for damages but the innocent debtors shall not contribute beyond their respective shares of the obligation. The obligation becomes a divisible one.

The above provision has already been explained under Article 1209.

**ART. 1225. For the purposes of the preceding articles, obligations to give definite things and those which are not susceptible of partial performance shall be deemed to be indivisible.**

**When the obligation has for its object the execution of a certain number of days of work, the accomplishment of work by metrical units, or analogous things which by their nature are susceptible of partial performance, it shall be divisible.**

**However, even though the object or service may be physically divisible, an obligation is indivisible if so provided by law or intended by the parties.**

**In obligations not to do, divisibility or indivisibility shall be determined by the character of the prestation in each particular case. (1151a)**

### Obligations deemed indivisible.

The above article lays down the general rule for determining the divisibility or indivisibility of an obligation. As has been seen, however, the purpose of the obligation is the controlling circumstance. This rule applies not only to obligations to give but also to those of doing or not doing. (4 Sanchez Roman 94.)

Divisible and indivisible obligations are not to be confused with divisible and indivisible contracts. (see Art. 1420.)

(1) *Obligations to give definite things* (par. 1.). —

EXAMPLES:

To give a particular electric fan; to deliver a specific car. Here, the obligation is indivisible because of the nature of the subject matter.

(2) *Obligations which are not susceptible of partial performance (Ibid.).* —

EXAMPLES:

To sing a song; to dance the *"tinikling."*

Here, the obligation is indivisible by reason of its purpose which requires the performance of all the parts.

Is the obligation still indivisible, if there are more than one participant? The obligation becomes divisible as far as the participants are concerned because it is capable of partial performance.

(3) *Obligations provided by law to be indivisible even if thing or service is physically divisible* (par. 3.). —

EXAMPLE:

Under the law, taxes should be paid within a definite period. Although money is physically divisible, the amount of tax payable must be delivered *in toto,* not partially.

(4) *Obligations intended by the parties to be indivisible even if thing or service is physically divisible* (par. 3.). —

EXAMPLES:

The obligation of D to give P1,000.00 to C on a certain date. Money is physically divisible but the clear intention here is for D to deliver P1,000.00 at *one time and as a whole.*

Suppose there are two debtors, D and E, is the obligation still indivisible? The obligation becomes divisible as far as D and E are concerned because the delivery of P1,000.00 can be done in parts, e.g., P500.00 by D and P500.00 by E. However, as far as C is concerned, the obligation remains indivisible because its performance cannot be done in parts.

**Obligations deemed divisible.**

(1) *Obligations which have for their object the execution of a certain number of days of work* (par. 1.). —

EXAMPLE:

The obligation of X to paint the house of Y, the painting to be finished in 10 days. Here, the obligation need not be fulfilled at one time.

(2) *Obligations which have for their object the accomplishment of work by metrical units (Ibid.).* —

EXAMPLES:

The obligation of X to make a table, 3 feet wide and 5 feet long; the obligation of X and Y to deliver 20 cubic meters of sand.

But the obligation of X alone to deliver 20 cubic meters of sand is indivisible.

(3) *Obligations which by their nature are susceptible of partial performance (Ibid.).* —

EXAMPLE:

The obligation of X to teach "Obligations and Contracts" for one year in a university; the obligation of Y to render 3 song numbers in a program; the obligation of Z to pay a debt of P12,000.00 in 12 monthly installments of P1,000.00 (see Soriano vs. Montes, 1 SCRA 366 [1961].) but each prestation to pay P1,000.00 is indivisible as it is to be delivered at one time and in its totality.

**Divisibility or indivisibility in obligations not to do.**

In negative obligations not to do, the character of the prestation in each particular case shall determine their divisibility or indivisibility. *(Ibid.)*

EXAMPLES:

(1) *Indivisible obligation.* — X obliged himself to Y not to sell cigarettes in his store for one year. Here, the obligation should be fulfilled *continuously* during a certain period.

(2) *Divisible obligation.* — If the obligation of X is not to sell cigarettes in his stores only during Sundays and holidays, the obligation is divisible because the forbearance is not *continuous.*

Obligations "to do" and "not to do" are generally indivisible. Obligations "to do" stated in paragraph 2 of Article 1225 are divisible.

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## SECTION 6. — *Obligations with a Penal Clause*

**ART. 1226. In obligations with a penal clause, the penalty shall substitute the indemnity for damages and the payment of interests in case of noncompliance, if there is no stipulation to the contrary. Nevertheless, damages shall be paid if the obligor refuses to pay the penalty or is guilty of fraud in the fulfillment of the obligation.**

**The penalty may be enforced only when it is demandable in accordance with the provisions of this Code. (1152a)**

### Meaning of principal and accessory obligations.

(1) *Principal obligation* is one which can stand by itself and does not depend for its validity and existence upon another obligation.

(2) *Accessory obligation* is one which is attached to a principal obligation and, therefore, cannot stand alone.

### Meaning of obligation with a penal clause.

An *obligation with a penal clause* is one which contains an accessory undertaking to pay a previously stipulated indemnity in case of breach of the principal prestation intended primarily to induce its fulfillment.

### Meaning of penal clause.

A *penal clause* is an accessory undertaking attached to an obligation to assume greater liability on the part of the obligor in case of breach of the obligation, *i.e.*, the obligation is not fulfilled, or is partly or irregularly complied with.

ILLUSTRATIVE CASE:

*Liability for non-fulfillment lesser than that provided by law.*

*Facts:* A clause in a deed of sale provides for the refund of the purchase price plus 4% interest *per annum* should the vendor fail to give the transfer certificate of title within six (6) months from date of full payment.

*Issue:* Is the clause a penal clause?

*Held:* No. Without said clause the vendee could recover legal interests under Article 2209 of the Civil Code which is even more than the 4% provided for in the clause. Therefore, it does not preclude the recovery of actual/nominal damages by the vendee. *(Robes-Francisco Realty & Dev. Corp. vs. CFI and Millan, 86 SCRA 59 [1978].)*

**Purposes of penal clause.**

They are:

(1) to insure their performance by creating an effective deterrent against breach, making the consequences of such breach as onerous as it may be possible. (Yulo vs. Chan Pe, 101 Phil. 134 [1957].) This is the general purpose of a penal clause; *and*

(2) to substitute a penalty for the indemnity for damages and the payment of interests in case of non-compliance (Art. 1226.); *or*

(3) to punish the debtor for the non-fulfillment or violation of his obligation.

A penal clause functions to strengthen the coercive force of the obligation by the threat of greater liability in the event of breach and to provide, in effect, for what would be the liquidated damages resulting from such a breach. The obligor would then be bound to pay the stipulated indemnity without the necessity of proof on the existence and on the measure of damages caused by the breach. (Ligutan vs. Court of Appeals, 376 SCRA 560 [2002]; Guatengco vs. Reyes, 574 SCRA 187 [2008].)

**Penal clause and condition distinguished.**

There are notable differences between the two.

(1) The first constitutes an obligation although accessory, while the latter does not; and

(2) Therefore, the former may become demandable in default of the unperformed obligation and sometimes jointly with it, while the latter is never demandable. (8 Manresa 244.)

**Penalty generally resolves question of damages.**

In the second case, *i.e.*, when the purpose is *reparation* or *compensation*, the matter of damages is generally resolved and the creditor is not obliged to prove them, the penalty being considered an anticipated valuation of the damages which may be suffered by the creditor if the obligation is not complied with; in the third, *i.e.*, when the purpose is *punishment*, the penalty does not resolve the question of damages, which it leaves intact (8 Manresa 245-246.), that is to say, damages may be recovered in addition to the penalty.

Under Article 1226, it is presumed, as a general rule, that the penalty serves as means of repairing the damages which it presupposes. A breach of contract entitles the other party to damages even if no penalty in such breach is prescribed in the contract.[1] (Boysaw vs. Interphil Promotions, Inc., 148 SCRA 636 [1987]; City of Manila vs. Intermediate Appellate Court, 179 SCRA 428 [1989].)

**Obligations with penal clause strictly construed.**

Obligations imposing penalties and forfeitures are strictly construed. Thus, it is well-settled that sureties are only chargeable according to the strict terms of the bond. The terms of their contract are those which measure the extent of their liability. (The Gov't. of the Phil. Islands vs. Herrero, 38 Phil. 410 [1918]; see also Asiatic Petroleum Co. vs. De Pio, 46 Phil. 167 [1924].)

**Distinguished from conditional, alternative, and facultative obligations.**

There is some analogy between these obligations, which sometimes serve to confuse them with each other.

EXAMPLE:

Suppose S makes the following promises to B:

(a) to convey to B house X, and if he fails, to pay B P500,000.00 (an obligation with a penal clause); or

[1]A "penalty fee" is likened to a compensation for *damages* in case of breach of an obligation. Being penal in nature, it must be specific and fixed by the contracting parties unlike in a case, for example, "which slaps a 3% penalty fee per month of the outstanding amount of the obligation." It is entirely different from "bank charges" which are normally understood to refer to compensation for *services*. (Viola vs. Equitable PCI Bank, Inc., 572 SCRA 245 [2008].)

(b) to pay P500,000.00, if he fails to convey to B house X (conditional obligation); or

(c) to convey house X to B or pay him P500,000.00 (alternative obligation); or

(d) to convey house X to B with the right to substitute the same with the payment of P500,000.00 (facultative obligation).

An analogy exists in all these obligations, in the sense that, in the proper cases contemplated, B may become the owner of house X or receive payment of P500,000.00.

But these obligations are essentially different in nature, and, therefore, in their effects and consequences.

(1) *In the obligation with a penal clause,* there is a principal obligation to which the accessory obligation of penal clause is joined. There is only one thing due, which the creditor may demand unaffected by the existence of the penal clause. The debtor cannot choose to pay the penalty in lieu of performance, except when expressly granted to him. (Art. 1227.)

The penal clause is a conditional obligation being demandable only when the condition on which it depends, that is, the non-performance of the obligation takes place. The existence of the principal obligation is certain, and the right of the creditor to demand its performance is further guaranteed by the penal clause. When the condition on which the penal clause depends takes place, then two obligations are demandable alternatively and, when there is express stipulation, jointly with the principal obligation. *(Ibid.)*

(2) *In the conditional obligation,* the existence of the obligation is uncertain. B cannot demand its performance until the (suspensive) condition takes place. And, if the condition does not take place, the obligation is deemed in law never to have existed.

(3) *In the alternative obligation,* while there is only one obligation, two things are due alternatively, and the obligation may be satisfied by the performance of one of them. The election belongs to the debtor, as a general rule, except when there is an agreement granting the right of choice to the creditor. (Art. 1200.)

The obligation is not extinguished by the fortuitous destruction or loss of the house in the example, but merely changes the obligation to a simple one. Not so in the case of the obligation with a penal clause;

when the house is destroyed by fortuitous event, the obligation is also extinguished. (Art. 1174.)

(4) *In the facultative obligation,* there is only one thing due notwithstanding the right conferred upon the debtor to satisfy the obligation by substituting another in its place.

The debtor may offer to satisfy the obligation by substituting the payment of P500,000.00 in lieu of the conveyance of the house. In the obligation with a penal clause, this the debtor cannot do, unless the obligation expressly reserves the right to him. (Art. 1227; see G. Florendo, The Law of Obligations and Contracts [1936], pp. 302-304, citing Laurent, Derecho Civil, Vol. 17, pp. 484-487.)

**Kinds of penal clause.**

They are:

(1) *As to its origin:*

(a) *Legal penal clause.* — when it is provided for by law; and

(b) *Conventional penal clause.* — when it is provided for by stipulation of the parties.

(2) *As to its purpose:*

(a) *Compensatory penal clause.* — when the penalty takes the place of damages; and

(b) *Punitive penal clause.* — when the penalty is imposed merely as punishment for breach.

(3) *As to its dependability or effect:*

(a) *Subsidiary or alternative penal clause.* — when only the penalty can be enforced; and

(b) *Joint or cumulative penal clause.* — when both the principal obligation and the penal clause can be enforced. (8 Manresa 215.)

**Liability for penalty, damages, and/or interests.**

(1) *Penalty substitutes for damages and interests.* — As a general rule, in an obligation with a penal clause, the penalty takes the place of the indemnity for damages and the payment of interests in case of non-compliance. (Art. 1226.) Proof of actual damages suffered by the creditor is not necessary in order that the penalty may be enforced. (Art. 1228.)

(2) *Penalty and interests enforceable.* — The law permits an agreement upon a penalty apart from the interest. Should there be such an agreement, the penalty does not include the interest and as such, the two are different and distinct things which may be demanded separately. A stipulation about payment of additional rate of interest partakes of the nature of a penalty clause which is sanctioned by law. (Insular Bank of Asia and America vs. Spouses Salazar, 159 SCRA 133 [1985].)

A penalty to answer not only for attorney's fees but for collection fees as well, is in the nature of liquidated damages. *(infra.)* Where the attorney's fees so provided are awarded in favor of the litigant not his counsel, it is the litigant, not his counsel, who is the judgment creditor entitled to enforce the judgment by execution. (Barons Marketing Corp. vs. Court of Appeals, 286 SCRA 96 [1998].)

(3) *Penalty, damages and interests enforceable.* — The creditor, in addition to the penalty, may recover damages and interests:

(a) When so stipulated by the parties;

(b) When the obligor refuses to pay the penalty; or

(c) When the obligor is guilty of fraud in the fulfillment of the obligation. (*Ibid.;* see Cabarroguis vs. Vicente, 107 Phil. 340 [1960]; Umali vs. Miclat, 105 Phil. 1109 [1957].)

When both the penalty and the damages or interests may be recovered, it is evident that the purpose of the penal clause is the punishment of the debtor for his breach of the principal obligation.

EXAMPLE:

S promised to deliver a specific car to B. The contract carried a penal clause that in case of non-compliance, S would have to pay a penalty of P20,000.00. S did not deliver the car and, as a consequence, B suffered damage in the amount of P15,000.00.

In this case, the penalty of P20,000.00 shall be paid. B cannot recover more than P20,000.00, the penalty stipulated, even if he proves that the damages suffered by him is P25,000.00.

The penalty substitutes the indemnity for the damage of P15,000.00, unless there is a stipulation to the contrary in which case, B may also recover the damages proved by him.

If S refuses to pay the penalty, B may recover legal interest thereon, the interest representing new damages brought about by the non-payment of the penalty.

If S is guilty of *fraud* (not mere fault) in the fulfillment of his obligation, he is also liable for the damages caused thereby in conformity with Article 1171. Proof of the fraud and the existence and amount of damages is incumbent upon B. But B need not prove fraud to recover the penalty.

(4) *Requirement to make penalty enforceable.* — The penalty may be enforced only when it is demandable in accordance with the provisions of the Civil Code. (*Ibid.*, par. 2.) This means that the penalty, as a stipulation in a contract, is demandable only if there is a breach of the obligation and it is not contrary to law, morals, good customs, public order, or public policy. (Art. 1306.) Thus, if the obligation cannot be fulfilled due to a fortuitous event, the penalty is not demandable. Under Article 1229, the penalty may be reduced if it is iniquitous or unconscionable or in case there is partial or irregular fulfillment.

**ART. 1227. The debtor cannot exempt himself from the performance of the obligation by paying the penalty, save in the case where this right has been expressly reserved for him. Neither can the creditor demand the fulfillment of the obligation and the satisfaction of the penalty at the same time, unless this right has been clearly granted him. However, if after the creditor has decided to require the fulfillment of the obligation, the performance thereof should become impossible without his fault, the penalty may be enforced. (1153a)**

### Penalty not substitute for performance.

Generally, the debtor cannot just pay the penalty instead of performing the obligation. Precisely, the object of the penalty is to secure compliance with the obligation. (Cui vs. Sun Chan, 41 Phil. 523 [1921].) If the debtor is allowed to just pay the penalty, this would in effect make the obligation an alternative one. (Art. 1199.)

The debtor can exempt himself from the non-fulfillment of the obligation only when "this right has been expressly reserved for him."

ILLUSTRATIVE CASES:

1. *Lessee invokes satisfaction of penalty as a defense to action by lessor for rescission of contract violated by former.*

*Facts:* E (lessee) bound himself "not to make any construction upon the property leased without the permission of R (lessor), and in case he should do, it shall be for the benefit of the property, without any right to ask for reimbursement for its cost."

In violation of this clause, E made some additions to the property.

*Issue:* Can R rescind the contract of lease even if E is willing to forfeit the improvements made on the property in favor of R?

*Held:* Yes. In an obligation with a penal clause, the penalty cannot, as a general rule, serve as a defense for the purpose of leaving the principal obligation unfulfilled. *(see Cui vs. Sun Chan, 41 Phil. 523 [1921].)*

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2. *Stipulated penalty was set-off against any amount due from or retained by the creditor under the contract.*

*Facts:* E agreed to build a chapel for Y for P16,000.00. It was provided that if either party should fail to comply with any of the stipulations of the contract, such party should pay to the other by way of indemnity the sum of P4,000.00. X was not a contractor by profession and knew nothing about constructing houses. The chapel was indeed constructed but the work was done with complete want of knowledge of the art of construction and of the materials employed.

On account of the delivery of the chapel, Y was still indebted to X for P4,000.00 which he refused to pay anymore. Later, Y brought action against X for the recovery of the stipulated penalty of P4,000.00. It appeared that Y was using the chapel for the purpose for which it was intended.

*Issue:* May Y be permitted to claim the stipulated penalty and at the same time keep the balance of the contract price.

*Held:* No. The damages to which Y is entitled under the contract must be set-off against the portion of the contract price which has been retained in his hands, with the result that neither party can recover anything from the other. *(Navarro vs. Mallari, 45 Phil. 242 [1923].)*

## Penal clause presumed subsidiary.

As a general rule, the creditor cannot demand the fulfillment of the obligation and the satisfaction of the penalty at the same time. The

primary purpose of the penalty is to urge the debtor to the performance of the main obligation.

(1) *Where there is performance.* — Once the obligation is fulfilled, this purpose is attained and, therefore, there is no need for demanding the penalty. The exception arises when "this right has been clearly granted" the creditor. Under Article 1227, therefore, the general rule is that a penal clause is subsidiary and not joint.

(2) *Where there is no performance.* — In case of non-compliance, the creditor may ask for the penalty or require specific performance. The remedies are alternative and not cumulative nor successive subject to the exception that the penalty may be enforced, if after the creditor has decided to require fulfillment, the same should become impossible without his fault. (see Art. 1191, par. 2.) If there was fraud on the part of the debtor, the creditor may recover the penalty as well as damages for non-fulfillment. (Art. 1226.)

**When penal clause joint.**

The debtor has the right to pay the penalty in lieu of performance only when this right has been *expressly* reserved for him.

With respect to the creditor, he has right to demand performance and payment of penalty jointly when this right has been *clearly granted* him. It is, therefore, not required that this right be expressly reserved for him; an implied grant clearly deducible from the evidence or the nature of the obligation is sufficient. Thus, when a penalty is stipulated for default in an obligation to pay a sum of money, it is clear that the creditor can demand both the principal obligation and the penalty with legal interest on the amount of the penalty from the date of demand where the debtor refuses to pay the penalty. (see Cabarroguis vs. Vicente, 107 Phil. 340 [1960]; Arts. 1169, 2209.)

**ART. 1228. Proof of actual damages suffered by the creditor is not necessary in order that the penalty may be demanded. (n)**

**Penalty demandable without proof of actual damages.**

In an obligation with a penal clause all that the creditor has to prove, to enforce the penalty, is the violation of the obligation by the debtor. It is not necessary to adduce evidence to prove losses and

damages suffered by the creditor or the extent of the same. Indeed, one of the reasons of fixing the penalty is to avoid such necessity and other difficulties involved in litigations.

The creditor may enforce the penalty whether he suffered damages or not. (Palacios vs. Municipality of Cavite, 12 Phil. 140 [1908]; Lambert vs. Fox, 26 Phil. 588 [1914]; General Insurance & Surety Corp. vs. Republic, 7 SCRA 4 [1963].) But he cannot recover more than the stipulated penalty even if he proves that the amount of his damages exceeds the penalty.

**Damages recoverable in addition to penalty must be proved.**

Article 1228 applies only where the penalty is fixed by the parties to substitute the indemnity for damages.

In any of the three exceptions when damages may be recovered in addition to the penalty (Art. 1227.), the creditor must prove the amount of such damages which he actually suffered resulting from the breach of the principal obligation.

**Penalty and liquidated damages distinguished.**

It has been held that "in this jurisdiction, there is no differences between a penalty and liquidated damages, so far as legal results are concerned. Whatever difference exists between them as a matter of language, they are treated the same legally. In either case, the party to whom payment is to be made is entitled to recover the sum stipulated without the necessity of proving damages. Indeed, one of the primary purposes in fixing a penalty or in liquidating damages is to avoid such necessity." (Lambert vs. Fox, 26 *supra.*) A stipulation on liquidated damages is a penalty clause where the obligor assumes a greater liability in case of breach of an obligation. (Titan Construction Corp. vs. Uni-Field Enterprises, Inc., 517 SCRA 180 [2007].) A surcharge or penalty stipulated in a loan agreement in case of default partakes of the nature of liquidated damages under Article 2227 of the Civil Code and is separate and distinct from interest payment. (Ruiz vs. Court of Appeals, 401 SCRA 410 [2003].)

In the new Civil Code, however, liquidated damages are dealt with separately from penal clauses, in Title XVIII, Chapter 3, Section

4. (Arts. 2226-2228.[2]) According to the Code Commission, liquidated damages are different from penalty, in that while the former are agreed damages, the latter is a punishment. True, both may be reduced (Art. 1229.), but their essential differences remain. (Memorandum of the Code Commission, March 8, 1951, p. 6; see Laureano vs. Kilayco, 32 Phil. 194 [1915], *infra*.)

The purpose of the penalty, however, may be reparation, not punishment. *(supra.)*

**ART. 1229. The judge shall equitably reduce the penalty when the principal obligation has been partly or irregularly complied with by the debtor. Even if there has been no performance, the penalty may also be reduced by the courts if it is iniquitous or unconscionable. (1154a)**

**When penalty may be reduced by the courts.**

The rule in Article 1229 is of evident justice. "Iniquitous and unconscionable stipulations on interest rates, penalties, and attorney's fees are contrary to morals." (Imperial vs. Jaucien, 427 SCRA 517 [2004].) The penalty provided for in the penal clause may be reduced by the courts:

(1) *When there is partial or irregular performance.* — The first refers to the extent of fulfillment, the latter, to the manner. The penalty should be more or less proportionate with the extent of the breach of the contract or of the damage suffered. It is to be presumed that the parties contemplate only a total breach of contract. (see Joe's Radio Electrical Supply vs. Alba Electronics Corp., 104 Phil. 333 [1958]; Tan vs. Court of Appeals, 367 SCRA 571 [2001].)

As a general rule, an obligation is not deemed performed unless the thing or service in which it consists has been completely delivered or rendered, as the case may be (see Arts. 1233, 1234, 1235, 1248.); or

[2]Art. 2226. Liquidated damages are those agreed upon by the parties to a contract, to be paid in case of breach thereof.

Art. 2227. Liquidated damages, whether intended as an indemnity or a penalty, shall be equitably reduced if they are iniquitous or unconscionable.

Art. 2228. When the breach of the contract committed by the defendant is not the one contemplated by the parties in agreeing upon the liquidated damages, the law shall determine the measure of damages, and not the stipulation.

(2) *When the penalty agreed upon is iniquitous or unconscionable.* — Here, the penalty may be reduced even if there is no performance at all. Even if iniquitous or unconscionable, liquidated damages, whether intended as an indemnity or as a penalty, are not void, but subject merely to equitable reduction. (see Art. 2227; Yulo vs. Chan Pe, 101 Phil. 134 [1957].) The question of whether a penalty is reasonable or iniquitous is addressed to the sound discretion of the court and on several factors, including, but not limited to, the following: the type, extent, and purpose of the penalty, the nature of the obligation, the mode of breach and its consequences, the supervening realities, the standing and relationship of the parties, the extent of the prejudice to the plaintiff, and the like. (Lo vs. Court of Appeals, 411 SCRA 523 [2003]; Pryce Corporation vs. PAGCOR, 458 SCRA 164 [2005].) Thus, it can be partly subjective and partly objective. (Ligutan vs. Court of Appeals, 376 SCRA 560 [2002]; Florentino vs. Supervalue, Inc., 533 SCRA 156 [2007].)

(a) In a case, it was held inequitable to have the amount of P101,550.00 paid by an installment buyer forfeited as liquidated damages, particularly after he had tendered the balance of P76,050.71 in full payment of his obligation. (McLaughlin vs. Court of Appeals, 144 SCRA 693 [1986].) But the forfeiture by the seller of P100,000.00 already paid by the purchaser of the property, pursuant to the clause of the contract providing that failure to pay any subsequent installment would forfeit installments already made, was held not iniquitous or unconscionable it appearing that the amounts forfeited constituted only 8% of the stipulated price. (Manila Racing Club, Inc. vs. Manila Jockey Club, 69 Phil. 55 [1939]; see National Power Corp. vs. National Merchandising Corp., 117 SCRA 789 [1982].)

(b) In another case, the Supreme Court ruled: "It is true that we have upheld the reasonableness of penalties in the form of attorney's fees consisting of Twenty-five percent (25%) of the principal debt plus interest. In the case at bar, however, the interest alone runs to some Four and a half million pesos (P4.5M) even exceeding the principal debt amounting to almost Four million pesos (P4.0M). Twenty-five percent (25%) of the principal and interest amounts to roughly Two million pesos (P2M). In real terms, therefore, the attorney's fees and collection fees are manifestly exorbitant. Accordingly, we reduce the same to Ten percent (10%)

of the principal. (Barons Marketing Corp. vs. Court of Appeals, 286 SCRA 96 [1998].)

(c) In a later case, the promissory note provides for a late payment penalty of 2.5% monthly, attorney's fees equivalent to 25% of the amount due in case a legal action is instituted, and 10% of the same amount as liquidated damages. *Held:* "Liquidated damages should no longer be imposed for being unconscionable. Such damages should be deemed included in the 2.5% monthly penalty. Furthermore, the petitioner is entitled only to 10% attorney's fees, the reasonable amount under the proven facts." (Radiowealth vs. Finance Company vs. Del Rosario, 335 SCRA 288 [2000].)

(d) In *Development Bank of the Philippines vs. Court of Appeals* (344 SCRA 492 [2000].), "private respondents made regular payments to petitioner DBP in compliance with their principal obligation. They failed only to pay on the dates stipulated in the contract. This indicates the absence of bad faith on the part of private respondents and their willingness to comply with the terms of the contract. Moreover, of their principal obligation in the amount of P207,000.00, private respondents have already paid P289,600.00 in favor of petitioner. These circumstances convince us of the necessity to equitably reduce the interest due to petitioner and we do so by reducing to 10% the additional interest of 18% *per annum* computed on total amortization past due. The penalty share of 8% *per annum* is sufficient to cover whatever else damages petitioner may have incurred due to private respondents' delay in paying the amortizations, such as attorney's fees and litigation expenses."

Although usury is now legally inexistent (see Art. 1175.) the interest at 5.5% per month or 66% *per annum* stipulated by the parties in a promissory note was held void for being iniquitous or unconscionable. (Medel vs. Court of Appeals, 299 SCRA 418 [1998].)

(e) In *Bulos, Jr. vs. Yasuma* (527 SCRA 727 [2007].), an interest rate of 4% per month or 48% *per annum* on the remaining balance of a loan obligation with a rural banks was held highly unconscionable and coordinate.

(f) The Supreme Court in *Rizal Commercial Banking Corp. vs. Court of Appeals* (289 SCRA 292 [1998].) has tempered the penalty charges after taking into account the debtor's spitiful situation and its offer to settle the entire obligation with the creditor. The

stipulated penalty might likewise be reduced when the debtor makes a partial or irregular performance. The stipulated penalty might even be deleted such as when there has been substantial performance in good faith of the obligor, when the penalty clause itself suffers from fatal infirmity, or when exceptional circumstances so exist as to warrant it.

(g) In *Lo vs. Court of Appeals (supra.),* the stipulated penalty was reduced by the appellate court for being unconscionable and iniquitous. As provided in the Contract of Lease, private respondent was obligated to pay a monthly rent of P30,000. On the other hand, the stipulated penalty was pegged at P5,000 for each day of delay or P150,000 per month, an amount five times the monthly rent. This penalty was not only exorbitant but also unconscionable, taking into account that private respondent's delay in surrendering the leased premises was because of a well-founded belief that its right of preemption to purchase the subject premises had been violated. Considering further that private respondent was an agricultural cooperative, collectively owned by farmers with limited resources, ordering it to pay a penalty of P150,000 per month on top of the monthly rent of P30,000 would seriously deplete its income and drive it to bankruptcy.

(h) In *United Coconut Planters Bank vs. Spouses Beluso* (530 SCRA 567 [2007].), it was ruled: "If a 36% interest in itself has been declared unconscionable by this Court, what more a 30.41% to 36% penalty, over and above the payment of compounded interest likewise imposed in the contract?" In *Chua vs. Timan* (562 SCRA 146 [2008].) and other cited cases: "stipulated interest rates of 3% per month and higher are excessive, iniquitous, unconscionable and exorbitant. Such stipulations are void, for being contrary to morals, if not against the law."

(i) In *Ligutan vs. Court of Appeals,* (376 SCRA 560 [2002].) petitioners borrowed P120,000 from a bank. The promissory note provides for the payment of 15.189% interest *per annum* and a penalty charge of 5% every month on the outstanding principal and interest in case of default. When the debtors failed to pay at maturity date and even after several extensions were given them, the bank sued for collection. The debtors asked for the reduction of the penalty for being unconscionable. Given the circumstances, not to mention the repeated acts of breach by the debtors of their contractual obligation, the Supreme Court found no cogent reason

to modify the award of 3% penalty a month from the 5% agreed upon.

(j) In determining whether a penalty is "iniquitous or unconscionable, a court may very well take into account the actual damages sustained by a creditor who was compelled to sue a defaulting creditor, which actual damages would include the interest and penalties the creditor may have had to pay on his own from his funding source. (Domel Trading Corporation vs. Court of Appeals, 315 SCRA 13 [1999].) Although the Supreme Court on various occasions has eliminated the 3% monthly penalty interest for being unconscionable, in a case, a reduction to 1% was considered more consistent with fairness and equity in view of the fact that the petitioner remained an unpaid seller and it suffered, one way or another, from respondent's non-performance of its contractual obligations. (Segovia Development Corporation vs. Dumatol Realty and Development Corporation, 364 SCRA 159 [2001]; see Imperial vs. Jaucian, 427 SCRA 517 [2004].)

(k) In *Patron vs. Union Bank of the Philippines* (569 SCRA 738), the penalty interest of 23% *per annum* was eliminated altogether for being unconscionable since "the purpose which the penalty interest is intended, that is to punish the obligor, will have been sufficiently served by the effects of compounded interest." (Patron vs. Union Bank of the Phils., 569 SCRA 738 [2008].)

*Note:* The Supreme Court had occasion to rule in a case that while the stipulated rate of interest (5.5% monthly), not penalty, was not usurious in view of the lifting by C.B. Circular No. 905 (Dec. 10, 1982) of the Usury Law ceiling on interest rates, the same must be equitably reduced if it is iniquitous or unconscionable. (Medel vs. Court of Appeals, 299 SCRA 481 [1998]; see Solangon vs. Salazar, 360 SCRA 379 [2001]; State Investment House, Inc. vs. Court of Appeals, 361 SCRA 201 [2001]; Reyes vs. Metropolitan Bank & Trust Co., 539 SCRA 564 [2007].) While the Usury Law ceiling on interest rates was lifted by C.B. Circular No. 905, nothing in the said circular grants lenders *carte blanche* authority to raise interest rates to levels which will either enslave their borrowers or lead to a hemorrhaging of their assets. (Spouses Solangon vs. Salazar, 360 SCRA 379 [2001].) If the interest rate agreed upon is void for being iniquitous and unconscionable, the rate of interest should be 12% *per annum* computed from judicial or extrajudicial demand. (Diño vs. Jardines, 481 SCRA 226 [2006]; see Art.

1175.), as what is voided is merely the stipulated rate of interest and not the stipulation that the loan shall earn interest. (United Coconut Planters Bank vs. Spouses Beluso, *supra*.)

ILLUSTRATIVE CASES:

1. *5 of the 20 guns lost were recovered.*

*Facts:* X, etc. (municipal officials) failed to return the 20 arms entrusted to them. This failure constituted a violation of the conditions of the bond given and made them subject to the penalty provided therein.

It appears that 5 of the 20 guns were recovered by third parties with the aid of X, etc. (municipal officials).

*Issue:* Should X, etc. be made liable for the full amount of the bond?

*Held:* The judgment of the trial court for the sum of P2,000 the full amount of the bond, should be reversed, and the recovery reduced to P1,500. (*Gov't. vs. Punzalan, 7 Phil. 546 [1907];* see Insular Gov't. vs. Amechezzura, 10 Phil. 637 [1908] and Treasurer of P.I. vs. Rodis, 80 Phil. 850 [1958].)

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2. *A greater part of the indebtedness has been paid.*

*Facts:* The stipulation is that D, debtor, shall pay P2,000 by way of indemnification, in the event of his failure to pay all or any part of an indebtedness of P102,200 and that C, creditor, should find it necessary to have recourse to the courts for the recovery of the money lent.

It appears that the principal indebtedness has been amply secured by a chattel mortgage, that the greater of the indebtedness has been paid at the time the action was brought, that D tendered payment in full-pending the proceedings in the trial court and deposited the amount together with 15% interest with the clerk of court, and substantial payments had been made by D long prior to the institution of the action.

*Issue:* Should D be made liable for the full amount of P2,000 as penalty?

*Held:* The trial court properly exercised the discretion conferred upon him by Article 1229 by modifying the penalties prescribed under the contract so as to limit the right of B to interest at the rate of 15% upon the last installments which had become overdue under the terms of the contract. (*Laureano vs. Kilayco, 32 Phil. 194 [1915]*; see Manila Trading and Supply Co. vs. Tamaraw Plantation Co., 47 Phil. 513 [1925], where the 13 1/2% of the amount for attorney's fees due as penalty was reduced to 12%.)

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3. *Out of P10,200.00 indebtedness only P3,433.75 is unpaid.*

*Facts:* D, etc., executed a written agreement wherein they obligated themselves to pay C P10,200.00 payable in monthly installments of P500.00; to pay interest at the rate of 15% on all overdue and unpaid installments; and to pay by way of indemnification, the sum of P2,000.00 should C be compelled to have recourse to the courts to recover the debt.

At the time of the trial there was still due and unpaid upon the last installments the sum of P3,433.75 which then and there D, etc., offered to pay, including the interest of 15% on said amount.

*Issue:* Is C entitled only to the interest of 15% upon the last installments which have become over due, or to both such interest and the stipulated indemnity of P2,000.00?

*Held:* Even when it is stipulated that the cost, losses and damages shall be chargeable to the debtor and be borne by him, the courts are authorized to modify the penalty stipulated in the contract in the sound exercise of their discretion when the principal obligation has been complied with by the debtor either in part or irregularly. *(Laureano vs. Kilayco, supra.)*

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4. *Debtor did not really expect that he would be made liable to pay the stipulated penalty which is excessive.*

*Facts:* D, etc. and their surety executed a promissory note binding themselves to pay C P465.00 within five (5) days, with a stipulated penalty of P5.00 a day in case of default.

*Issue:* Is the stipulated penalty valid?

*Held:* No. In said promissory note the debtors bound themselves to pay P465.00 within five (5) days, in the belief that they could make the payment during this short period with the price from the sale of D's land, but, as this sale was not made in the end, he had no money with which to cover his liability; and it cannot be presumed that D and his surety voluntarily wished to assume the engagement to pay the penalty in question, and without doubt their failure of fulfillment was due to their erroneous belief that within five (5) days they would have the money available for the payment, which they did not to their great disappointment.

"Such penal clause is immoral and eminently unjust, and would be tantamount to a repugnant despoliation and iniquitous and merciless deprivation of property, discountenanced by common sense. There will not be found in the laws, in any principle of justice, or in general, in the human conscience, nor is there any reason whatever which can justify such penalty as appropriate and equitable or as one that may be sustained

within the sphere of public or private morals." *(Ibarra vs. Aveyro and Pre, 37 Phil. 273 [1917].)*

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5. *Payment of the stipulated penalty would amount to a clearly iniquitous deprivation of property.*

*Facts:* A and B bought a parcel of land from C (for P716,573.00)with the unpaid balance of the purchase price of P576,573.00) secured by a mortgage thereon. Later, A sold his interest in the land to B, A receiving P22,285.00 with the balance of P22,285.00 to be paid within eight (8) months. It was agreed that in case of failure to pay the balance, B would pay a penalty of P6,367.00 annually for the next period of three (3) years, plus interest at the legal rate on the balance and the penalties unpaid. B failed to pay not only the balance of their obligation to C but also the balance of his obligation to A.

It appears that B was the one who paid out of his personal funds the down payment of P140,000.00 with the understanding that A would reimburse B his 1/2 (P70,000.00) share. The sum of P20,000.00 was the only amount paid by A to and/or invested with B.

*Issue:* Is A entitled to the penalties and the interests stipulated?

*Held:* No. A more than broke even on his investment of P20,000.00 when he received from B the sum of P22,285.00. Justice and morality cannot consent to and sanction a clearly iniquitous deprivation of property repulsive to the common sense of man. (*De Cortez vs. Venturanza, 79 SCRA 709 [1977];* see Baron Marketing Corp. vs. Court of Appeals, 286 SCRA 96 [1998]; Palmares vs. Court of Appeals, 288 SCRA 422 [1998].)

### Construction of penal clause where performance partial or irregular.

(1) *Where penalty is punitive.* — In any case wherein there has been a partial or irregular compliance with the provisions of a contract with a penal clause, the courts will rigidly apply the doctrine of strict construction against the enforcement in its entirety of the penalty, where it is clear from the terms of the contract that the amount or character of the indemnity is fixed without regard to the probable damages which might be anticipated as a result of the breach of the terms of the contract; or in other words, where the indemnity provided for is essentially a mere penalty having for its principal object the enforcement of compliance with the contract. (Laureano vs. Kilayco, 32 Phil. 194 [1915]; General Insurance & Surety Corp. vs. Republic, 7 SCRA 4 [1963].)

ILLUSTRATIVE CASE:

*Purpose of penalty stipulated is not to indemnify but to induce performance.*

*Facts:* The contract of sale of a residential lot stipulates that B (vendee) must complete construction within two years from the date (March 31, 1959) of the sale 50% of his residence on the lot, and in the event of his failure to comply with this "special condition," B would pay S (vendor) the sum of P12,000.00 for which B gave a surety bond. B did not build the house, instead he sold the lot to C. S made a demand for the payment of P12,000.00 as neither B nor C built a house on the lot within the stipulated period.

It appeared that even before the target date (March 31, 1961), the entire area was already fenced with a stone wall and building materials were also stocked in the premises and by the end of April, 1961, C had finished very much more than the required 50% stipulated.

*Issues:* (1) What is the nature of the so-called "special condition" in the contract of sale?

(2) Should B be held liable for the full amount of his bond?

*Held:* (1) It is in reality a penal clause to secure the performance of B's obligation.

(2) No. There was partial performance of the obligation within the meaning and intendment of Article 1229. The penal clause in this case was inserted not to indemnify S for any damage it might suffer as a result of a breach of the contract but rather to compel performance of the so-called "special condition" and to encourage home building — among lot owners in the area (Urdaneta Village).

Considering that a house had been built after the period stipulated, the substantial, if tardy, performance of the obligation, having in view the purpose of the penal clause, justified the reduction (by the trial court) of the penalty to P1,500 (plus 12% interest from the time of the filing of the complaint plus P500.00 for attorney's fees and costs). The stipulation cannot be construed as imposing a strictly personal obligation on the vendee (B). To adopt such a construction would be to limit his right to dispose of the lot. Such restriction cannot be left to mere inference. *(Makati Development Corp. vs. Empire Insurance Co., 20 SCRA 557 [1967].)*

(2) *Where penalty is compensatory.* — But the courts will be slow in exercising the authority conferred upon them in Article 1229 where it appears that in fixing the indemnity the parties had in mind a fair and reasonable compensation for actual damages anticipated as a result

of the breach of the contract; or, in other words, where the principal purpose of the penalty agreed upon appears to have been to provide for the payment of actual anticipated and liquidated damages rather than the penalization of a breach of the contract. (see Laureano vs. Kilayco, 32 Phil. 194 [1915].)

"It's true that it was said in a former decision (Lambert vs. Fox, *supra*.) that in this jurisdiction there is no substantial difference between a penalty and liquidated damages so far as legal results are concerned but this statement . . . is strictly applicable only to cases wherein there has been neither a partial nor irregular compliance with the terms of the contract, so that the courts have no authority to equitably reduce the penalty." *(Ibid.)* Under Article 1229, however, the penalty may also be reduced by the courts if it is iniquitous or unconscionable although there has been no performance by the debtor.

The second sentence of Article 1229 is new.

**ART. 1230. The nullity of the penal clause does not carry with it that of the principal obligation.**

**The nullity of the principal obligation carries with it that of the penal clause. (1155)**

### Effect of nullity of the penal clause.

The general principle that the accessory follows the principal and not *vice versa* is illustrated in the above article.

If only the penal clause is void, the principal obligation remains valid and demandable. The penal clause is just disregarded. The injured party may recover indemnity for damages in case of non-performance of the obligation as if no penalty had been stipulated. (see Art. 1170.)

### Effect of nullity of the principal obligation.

If the principal obligation is void, the penal clause is likewise void. The reason is that the clause cannot stand alone without the principal obligation to which it is subordinated.

But if the nullity of the principal obligation is due to the fault of the debtor who acted in bad faith, by reason of which the creditor suffered damages on equitable grounds, the penalty may be enforced. (see Arts. 10, 19, 20, 21.)

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# Chapter 4

# EXTINGUISHMENT OF OBLIGATIONS

## GENERAL PROVISIONS

**ART. 1231. Obligations are extinguished:**

**(1) By payment or performance;**

**(2) By the loss of the thing due;**

**(3) By the condonation or remission of the debt;**

**(4) By the confusion or merger of the rights of creditor and debtor;**

**(5) By compensation;**

**(6) By novation.**

**Other causes of extinguishment of obligations, such as annulment, rescission, fulfillment of a resolutory condition, and prescription, are governed elsewhere in this Code. (1156a)**

### Causes of extinguishment of obligations.

In addition to those enumerated in Article 1231, other causes are:

(1) Death of a party in case the obligation is a personal one (Art. 1311, par. 1.);

(2) Mutual desistance or withdrawal;

(3) Arrival of resolutory period (Art. 1193, par. 2.);

(4) Compromise (Art. 2028.);

(5) Impossibility of fulfillment (Art. 1266.); and

(6) Happening of a fortuitous event. (Art. 1174.)

These causes as well as those enumerated in the second paragraph of Article 1231 are governed under other chapters of the Civil Code.

Under No. 2, where after the approval of his loan, the borrower, instead of insisting for its release, asked that the mortgage given by him as security be cancelled and the creditor (DBP) acceded thereto, the action thus taken by both parties was held in the nature of mutual desistance — what Manresa terms *"mutuo disenso"* — which is a mode of extinguishing obligations. It is a concept that derives from the principle that since mutual agreement can create a contract, mutual disagreement by the parties can cause its extinguishment. (see Saura Import & Export Co., Inc. vs. Development Bank of the Phil., 44 SCRA 445 [1972]; see Art. 1308.)

In another case, the Supreme Court ruled: "Even granting there was a perfected contract of sale, it can be implied that there was subsequently a mutual withdrawal or 'mutual backing out' from the contract. This conclusion may be drawn from the fact of the filing by private respondent [seller] of the complaint for ejectment, in which he alleged ownership of the property in question and from the averments in petitioners' answer wherein they never claimed ownership of the property by purchase from private respondent." (Pagco vs. Court of Appeals, 231 SCRA 354 [1994].)

**Modes of extinguishment of obligations classified.**

Castan classifies the modes of extinguishing obligations in the following manner:

(1) *Voluntary:*

(a) Performance:

1) Payment; and

2) Consignation.

(b) Substitution:

1) *Dacion en pago* (conveyance for payment); and

2) Novation.

(c) By release agreement:

1) Agreement subsequent to the constitution of the obligation:

a) Mutual waiver;

b) Unilateral waiver; and

c) Remission.

2) Agreement simultaneous to the constitution of the obligation:

a) Resolutory condition; and

b) Extinctive period.

(2) *Involuntary:*

(a) By reason of the subject:

1) Confusion; and

2) Death of the contracting parties in the cases where the obligations are personal.

(b) By reason of the object:

1) Loss of the thing due or impossibility of performance; and

(c) By failure to exercise (right of action):

1) Extinctive prescription. (see G. Florendo, The Law of Obligations and Contracts [1936], pp. 333-334, citing 2 Castan, *Derecho Civil Español*, 46-47.)

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# SECTION 1. — *Payment or Performance*

**ART. 1232. Payment means not only the delivery of money but also the performance, in any other manner, of an obligation. (n)**

### Meaning of payment.

In ordinary parlance, payment refers only to the delivery of money. As a mode of extinguishing an obligation, it has a much wider meaning.

*Payment* may consist of not only in the delivery of money but also the giving of a thing (other than money), the doing of an act, or not doing of an act. When a debtor pays damages or penalty in lieu of the fulfillment of an obligation (see Art. 1226.), there is also payment in the sense used in Article 1232.

In law, payment and performance are synonymous.

### Elements of payment.

Matters relative to ordinary or common payment, without regard to form, are distinguished from those referring to certain exceptional manifestations of the same, as tender and consignation of payment, assignment, and cession of properties. This distinction is accepted by the Civil Code, which treats first of the common doctrine of payment and then of the special forms under separate titles.

Under the common law doctrine and the same traditional influence, the elements of payment are analyzed into:

(1) persons, who may pay and to whom payment may be made;

(2) thing or object in which payment must consist;

(3) the cause thereof;

(4) the mode or form thereof;

(5) the place and the time in which it must be made;

(6) the imputation of expenses occasioned by it; and

(7) the special parts which may modify the same and the effects they generally produce — elements which are designated in Latin *quis, quinam, quid, causa, quo modo, ubi, quando, expensae,* and *pacta adjunta.* (G. Florendo, The Law of Obligations and Contracts [1936], p. 335, citing 8 Manresa 260-261.)

**Burden of proving payment.**

*Burden of proof* is the duty of a party to present evidence of the facts in issue necessary to prove the truth of his claim or defense by the amount of evidence required by law. (Dela Peña vs. Court of Appeals, 579 SCRA 396 [2009].)

When the existence of a debt is fully established by the evidence, the settled rule is that the burden of proving extinguishment by payment devolves upon the debtor who pleads payment or offers such a defense to the claim of the creditor rather than on the latter to prove non-payment. The debtor has the burden of showing with legal certainty that the obligation has been discharged by payment.[1] Only when the debtor introduces evidence that the obligation has been extinguished does the burden shift to the creditor. (Biala vs. Court of Appeals, 191 SCRA 51 [1990]; Good Earth Emporium, Inc. vs. Court of Appeals, 194 SCRA 544 [1991]; Audion Electric Co., Inc. vs. National Labor Relations Commission, 308 SCRA 340 [1999]; Far East Bank and Trust Co., Inc. vs. Querimit, 373 SCRA 665 [2002]; Coronel vs. Capati, 459 SCRA 205 [2005]; G.M. [Phil.], Inc. vs. Batomalaque, 461 SCRA 111 [2005]; G & M Phils., Inc. vs. Cuambot, 507 SCRA 552 [2006]; Bulos,

[1]A receipt of payment, although not exclusive, is deemed to be the best evidence of payment. A *receipt* is a written and signed acknowledgment that money has or goods have been delivered, while *voucher* is a documentary record of a business transaction. A voucher is not necessarily an evidence of payment. It is merely a way or method of recording or keeping track of payments made. (Alonzo vs. San Juan, 451 SCRA 45 [2005].) In the world of business, it is unnatural to make payments and allow them to be unrecorded. (Union Refinery Corporation vs. Tolentino, Sr., 471 SCRA 613 [2005].) A cancellation of mortgage (*i.e.*, release of a real estate mortgage) is not conclusive proof of payment of a loan, even as it may serve as basis for an inference that payment of the principal obligation has been made. (Co vs. Admiral United Savings Bank, 551 SCRA 472 [2008].) Neither is an invoice in and by itself, as opposed to a receipt, considered as evidence of payment, nor does its possession by the debtor raises the presumption of payment. In fact, the term "invoice" indicates that money is owing or owed. (Royal Cargo Corp. vs. DFS Sports Unlimited, Inc., 573 SCRA 414 [2008].)

Jr. vs. Yasuma, 527 SCRA 727 [2007]; Cham vs. Paita-Moya, 556 SCRA [2008].)

There is a disputable presumption that money paid by one to another was due to the latter. (Rules of Court, Rule 131, Sec. 5[f].)

**ART. 1233. A debt shall not be understood to have been paid unless the thing or service in which the obligation consists has been completely delivered or rendered, as the case may be. (1157)**

### When debt considered paid.

A debt may refer to an obligation to deliver money, to deliver a thing (other than money), to do an act, or not to do an act. *(supra.)*

(1) *Integrity of the prestation.* — This requisite means that the prestation be fulfilled completely. (Alonzo vs. San Juan, 451 SCRA 45 [2005].) A debt to deliver a thing (including money) or to render service is not understood to have been paid unless the thing or service has been completely delivered or rendered, as the case may be. Partial or irregular performance will not produce the extinguishment of an obligation as a general rule.

Neither a late partial payment forestall a long-expired maturity date. (Selegna Management & Dev. Corp. vs. United Coconut Planters Bank, 489 SCRA 125 [2006].)

EXAMPLES:

(1) D bound himself to pay C P10,000.00. D is giving only P9,000.00. C can refuse to accept P9,000.00 because the fulfillment is not complete.

(2) X agreed to paint the house of Y for P50,000.00. X did not paint the kitchen anymore and instead asked Y to pay him P50,000.00 less the cost of painting the kitchen. Y can refuse to pay X because the debt of Y (to deliver money) will arise only after the debt of X (to paint the house) is completely rendered. (see Art. 1191.)

(2) *Identity of the prestation.* — This second requisite means that the very prestation due must be delivered or performed. (see Art. 1244.)

**ART. 1234. If the obligation has been substantially performed in good faith, the obligor may recover as though there had been a strict and complete fulfillment, less damages suffered by the obligee. (n)**

**Recovery allowed in case of substantial performance in good faith.**

Article 1234 is the first exception to the rule laid down in Article 1233. The reason for the exception given by the Code Commission is as follows:

> "The above rule (Art. 1234.) is adopted from American Law. Its fairness is evident. In case of substantial performance, the obligee is benefited. So the obligor should be allowed to recover as if there had been a strict and complete fulfillment less damages suffered by the obligee. This last condition affords a just compensation for the relative breach committed by the obligor." (Report of the Code Commission, p. 131.)

**Requisites for the application of Article 1234.**

The requisites are:

(1) There must be substantial performance. Its existence depends upon the circumstances of each particular case; and

(2) The obligor must be in good faith. Good faith is presumed in the absence of proof to the contrary. (see Duran vs. Intermediate Appellate Court, 138 SCRA 489 [1985]; Tan vs. G.V.T. Engineering Services, 498 SCRA 93 [2006].)

EXAMPLE:

S obliged himself to sell 1,000 bags of cement to B for a certain price. However, despite diligent efforts on his part, S was able to deliver only 950 bags because of cement shortage. Take note that S wants to comply with his obligation to deliver the entire 1,000 bags but he could not do so for reasons beyond his control.

Under Article 1234, S can recover as though there had been complete delivery less the price of the 50 bags. In other words, B cannot require S to deliver first the remaining 50 bags as a condition to his liability for the price. He must pay for the 950 bags and enforce his right to damages for failure of S to deliver the difference. It is incumbent upon S, however, to explain satisfactorily his failure to make complete delivery.

ILLUSTRATIVE CASE:

*Cancellation of only one contract where there are two contracts to sell covering two lots and total payments by the buyer are more than value of one lot.*

*Facts:* S, as subdivision owner, agreed to sell under two contracts two lots to B on installments for a period of 10 years, covering 120 monthly installments. The contract provides that failure of B to pay the principal plus interest would mean the cancellation of the contract and the forfeiture of all the amounts paid. After the 95th installments for both lots, B did not make further payments. S cancelled the contract and forfeited the amounts paid. The amount paid by B on the principal alone (P1,682.00) was more than the value of one lot (P1,500.00).

The Court of Appeals ordered the cancellation of only one contract and the conveyance of one lot of B's choice, while recognizing the right of S to retain the interests (P1,890.00) paid by B on both lots for eight (8) years.

*Issue:* Does the decision deny substantial justice to S?

*Held:* No. Under the decision, the interests paid by B are retained by S, and the other lot reverts to S by reason of the cancellation of the contract as to said lot. The judgment cannot be deemed to deny substantial justice to S nor to defeat his rights under the letter and spirit of the contracts in question. In the interest of justice and equity, the decision may be upheld upon the authority of Article 1234.[2] *(Legarda Hermanos vs. Saldana, 55 SCRA 324 [1974].)*

**ART. 1235. When the obligee accepts the performance, knowing its incompleteness or irregularity, and without expressing any protest or objection, the obligation is deemed fully complied with. (n)**

## Recovery allowed when incomplete or irregular performance waived.

The above provision is the other exception to Article 1233. It is founded on the principle of estoppel. In case of acceptance, the law considers that the creditor waives his right. The whole obligation is extinguished.

If the payment is incomplete or irregular, the creditor may properly reject it.

[2]A level of work accomplishment of 97.56% complete would by any national norm be considered as substantial to warrant full payment of the contract amount, less actual damages suffered by the principal. (Diesel Construction Co., Inc. vs. UPSI Property Holdings, 549 SCRA 12 [2008].)

**Requisites for the application of Article 1235.**

The requisites are:

(1) The obligee knows that the performance is incomplete or irregular; and

(2) He *accepts* the performance without expressing any protest or objection.

**Meaning of "accept," as used in Article 1235.**

The verb "accept," as used in Article 1235, means to take as "satisfactory or sufficient," or to "give assent to," or to "agree" or "accede" to an incomplete or irregular performance. The mere receipt of partial payment is not equivalent to acceptance of performance within the purview of Article 1235 as would extinguish the whole obligation. (Esguerra vs. Villanueva, 21 SCRA 1314 [1967]; Castro vs. Court of Appeals, 384 SCRA 607 [2002].)

(1) When a creditor receives partial payment, he is not *ipso facto* deemed to have abandoned his prior demand for full payment. To imply that a creditor accepts partial payment as complete performance, his acceptance must be made under circumstances that indicate his intention to consider the performance complete and to renounce his claim arising from the defect. (Selegna Management and Dev. Corp. vs. United Coconut Planters Bank, 489 SCRA 125 [2006].)

(2) In a case, it was held that the failure of the respondent to object or protest the non-payment of interest by the petitioner who incurred delay in the settlement of its obligations, when the former accepted the certificate of title to a subdivision lot sold by way of settlement of a criminal case, cannot be considered as full payment of the principal obligation in the civil case, thus precluding recovery of interest under Article 1235. Only the principal obligation was considered to have been paid or performed. Having incurred delay in the settlement of its obligation, the petitioner cannot deny the respondent its right to collect interest pursuant to Article 2209 of the Civil Code. (Solid Homes, Inc. vs. Court of Appeals, 170 SCRA 63 [1989].)

(3) In another case, however, where the seller accepts the buyer's installment payments despite the alleged charges incurred by the latter, without qualification, without any specific demand for them,

and without any showing that he protested the irregularity of such payment, the buyer's liability, if any, for such charges, was deemed fully satisfied the seller having waived the same. (Palanca vs. Guides, 452 SCRA 461 [2005].)

**Form of protest of creditor.**

Article 1235 does not require the protest or objection of the creditor to be made in a particular manner or at a particular time. So long as the acts of the creditor, at the time of the incomplete or irregular payment by the debtor, or within a reasonable time thereafter, evince that the former is not satisfied or agreeable to said payment or performance, the obligation shall not be deemed extinguished. (Esguerra vs. Villanueva, *supra.*)

**ART. 1236. The creditor is not bound to accept payment or performance by a third person who has no interest in the fulfillment of the obligation, unless there is a stipulation to the contrary.**

**Whoever pays for another may demand from the debtor what he has paid, except that if he paid without the knowledge or against the will of the debtor, he can recover only insofar as the payment has been beneficial to the debtor. (1158a)**

**Persons from whom the creditor must accept payment.**

The creditor is bound to accept payment or performance from the following:

(1) The debtor;

(2) Any person who has an interest in the obligation (like a guarantor); or

(3) A third person who has no interest in the obligation when there is stipulation that he can make payment. (par. 1.)

**Creditor may refuse payment by a third person.**

"Under the old Civil Code, the creditor cannot refuse payment by a third person but the Commission believes that the creditor should have a right to insist on the liability of the debtor. Moreover, the creditor should not be compelled to accept payment from a third person whom he may dislike or distrust. The creditor may not, for personal

reasons, desire to have any business dealings with a third person; or the creditor may not have confidence in the honesty of the third person who might deliver a defective thing or pay with a check which may not be honored." (Report of the Code Commission, p. 132.)

"Or he might be the creditor's bitter enemy. Or suppose the contract is to sell a horse, or a car of a certain make, or a tractor. Can a total stranger compel the creditor to accept the horse, or the car, or the tractor that he (former) is delivering to him? How could the creditor be absolutely sure that the thing delivered is in accordance with the contract?" (Memorandum of the Code Commission, *supra*, p. 8.)

**Effect of payment by a third person.**

The second paragraph of Article 1236 recognizes that payment or performance may be made by any person not incapacitated, even without the knowledge or against the will of the debtor, and although he has absolutely no interest in the obligation. Such payment would produce an enforceable right in favor of the paying third person.

(1) *If made without the knowledge or against the will of debtor.* — The payer can recover from the debtor only in so far as the payment has been beneficial to the latter. (par. 2.) In other words, the recovery is only up to the extent or amount of the debt at the time of payment. Furthermore, the third person is not subrogated to the rights of the creditor, such as those arising from a mortgage, guarantee, or penalty. (Art. 1237; see Art. 1425.)

(2) *If made with the knowledge of the debtor.* — The payer shall have the rights of reimbursement and subrogation, that is, to recover what he has paid (not necessarily the amount of the debt) and to acquire all the rights of the creditor. (Arts. 1236, par. 2; 1237, 1302, 1303.)

EXAMPLES:

D owes C the sum of P1,000.00. If S, a stranger to the obligation, offers to pay C, the latter may or may not accept the offer of payment. Suppose C accepts, the right of S to recover from D depends upon whether the payment is with or without the knowledge or consent of D.

(1) *Without the knowledge (or against the will) of D* — If the actual indebtedness is P1,000.00 and S paid P1,000.00, he can ask reimbursement for P1,000.00 but if P400.00 had already been paid by D, then S is entitled to be reimbursed only for the amount of P600.00 because it is only to that amount that D has been benefited. S can recover P400.00 from C who should not have accepted it.

If C acted in bad faith, he is liable also for interest in lieu of damages.

(2) *With the knowledge of D* — In either case, if the payment of P1,000.00 was made with the knowledge or consent of D, S can recover from D P1,000.00 with all the rights of subrogation to the accessory obligations such as mortgage, guaranty, or penalty. (Art. 1237.)

ILLUSTRATIVE CASES:

1. *Right of judgment creditor (or transferee) to whom was sold at an execution sale a vendor a retro's (judgment debtor's) right of repurchase, to have the property repurchased by the latter from the vendee a retro registered in the name of such judgment creditor.*

*Facts:* S sold a parcel of land with right to repurchase to B. S's right which was annotated in the registry records, was later attached by C and sold under execution. Because of the failure of S to redeem the property within one year from the date of execution sale, a deed for the interest of S in the land was issued to C, who was the purchaser at said sale.

In the meantime, S repurchased the land from B, and the annotation of the right to redeem was cancelled. Subsequently, C, in turn, sold all his interests in the land to D who now seeks to have the land registered in his name claiming that under Article 1158 (now Art. 1236.) the repurchase by S was a payment for C and that S may recover from C the price paid.

*Issue:* Was the repurchase by S a payment for C?

*Held:* No. The only interest acquired by C at the sheriff's sale was the right to repurchase from B because this was the only interest that S had at that time. D's claim of ownership of the land based on his subsequent purchase from C, the judgment creditor, was invalid, as the latter did not acquire title by the repurchase of the land under the *pacto de retro* contract by S, the judgment debtor.

C was not a debtor of B, the *pacto de retro* vendee. He was under no obligation to repurchase the land from B. C had the right to do so but the exercise of the right was optional with him. Therefore, the repurchase by S (for himself) did not make C or D, C's transferee, the owner of the land. Article 1236 is not applicable. *(Gonzaga vs. Garcia, 27 Phil. 7 [1914].)*

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2. *Redemption was made by an uncle in behalf of minors, the owners of property sold in execution.*

*Facts:* A parcel of land belonging to M, etc., minors, was sold in execution to B. C, an uncle of M, etc. deposited with the sheriff in their behalf but without their knowledge, the redemption price and interest on

the last day for redemption. B refused to turn over the land on the ground that there was no valid redemption because C was not the legal guardian of the minors.

The guardian died a few days before the period of redemption expired.

*Issue:* Was the redemption valid?

*Held:* Yes. Any person, whether he has an interest in the redemption or not can make payment in behalf of the minors, the debtors, without the knowledge of the latter. *(Sison vs. Balgor, 34 Phil. 885 [1916].)*

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3. *Rights acquired by a third person who paid taxes for the account of a delinquent taxpayer.*

*Facts:* For failure of the heirs of X, to pay the real estate taxes on the land in dispute, the same was forfeited to the government. To avoid its eventual sale at public auction, B, one of the heirs, asked C to pay the amount of said taxes which C did. Receipts for payment were issued to C "in behalf of the declared owner, X."

C contends that he has acquired by virtue of said payment the rights of X in and to said property.

*Issue:* What is the effect of the payment made by C?

*Held:* The delinquent taxpayer in this case is the estate of X, not C, so that payment by C merely subrogated him into the rights of the government *as creditor* for said delinquent taxes under Article 1236. The fact that C accepted said receipts issued in the name of X, indicates that C understood that he was not thereby purchasing the property, but had made the payment for the account or benefit of X. C became a trustee for the benefit of X or his heirs. *(Villarta vs. Cuyno, 17 SCRA 100 [1966].)*

**Payment with/without the knowledge or against the will of the debtor.**

(1) The provision that the payor (or payer) "can recover only insofar as the payment has been beneficial to the debtor," when made without his knowledge or against his will, is a defense that may be availed of only by the debtor, not by the creditor, for it affects solely the rights of the former. Once the creditor has accepted payment, his status and rights as such, become automatically extinguished. (Rehabilitation Finance Corp. vs. Court of Appeals, 94 Phil. 984 [1954].)

(2) If the third person pays with the knowledge of the debtor, the latter must oppose the payment before or at the time the same was

made, not subsequently, in order that the rights of the payor may be subject to the above provision. It is only fair that the effect of said payment be determined at the time it was made, and that the rights then acquired by the payor be not dependent upon, or subject to modification by subsequent unilateral acts of the debtor. The question whether the payment was beneficial or not to the debtor, depends upon the law, not upon his will. *(Ibid.)*

**ART. 1237. Whoever pays on behalf of the debtor without the knowledge or against the will of the latter, cannot compel the creditor to subrogate him in his rights, such as those arising from a mortgage, guaranty, or penalty. (1159a)**

### Right of third person to subrogation.

Whoever pays on behalf of the debtor is entitled to subrogation if the payment is with the consent of the latter. (Arts. 1237, 1302[2].) If the payment is without the knowledge or against the will of the debtor, the third person cannot compel the creditor to subrogate him in the latter's accessory rights of mortgage, guaranty, or penalty.

May there be subrogation, if the creditor willingly permits the payor to be subrogated in his rights? Since the provision of Article 1237 is for the benefit of the debtor, the subrogation can only take place with his consent. The third person who without necessity paid under such condition is amply protected by his right to reimbursement. (see 8 Manresa 271-273.)

Articles 1236 and 1237 do not apply where no debtor-creditor relationship exists between the person on whose behalf the payment was made and the payee. (see Tanguilig vs. Court of Appeals, 266 SCRA 78 [1997].)

Legal subrogation by operation of law is presumed in certain cases. (see Art. 1302.)

### Subrogation and reimbursement distinguished.

(1) In subrogation, the person who pays for the debtor is put into the shoes of the creditor. The payer acquires not only the right to be reimbursed for what he has paid but also all other rights which the creditor could have exercised pertaining to the credit either against the

debtor or against third persons, be they guarantors or possessors of mortgages. (Art. 1303.)

(2) In reimbursement, the third person entitled by reason of payment has merely the bare right to be refunded to the extent provided in the second paragraph of Article 1236 without the right to the guarantees and securities of the original obligation. In subrogation, however, there is no real extinction of the obligation, but only a change of creditor.

EXAMPLE:

D borrowed from C P1,000.00. G is the guarantor. Without the knowledge or consent of D, X paid C P1,000.00.

In this case, X can claim reimbursement from D for the whole amount of P1,000.00 inasmuch as D was benefited up to that amount. (Art. 1236.) If D cannot pay X, the latter cannot proceed against G, the guarantor (even if C is willing) because, having paid without the consent of D, X is not entitled to subrogation. But if the payment was with the express or tacit approval of D, X would be entitled not merely to full reimbursement but also to subrogation.

Suppose the obligation of D is secured by a mortgage of a land owned by D. Payment by X without the knowledge or against the will of D, cannot give X the right to foreclose the mortgage because he has no right to subrogation. X can recover only insofar as the payment has been beneficial to D.

**ART. 1238. Payment made by a third person who does not intend to be reimbursed by the debtor is deemed to be a donation, which requires the debtor's consent. But the payment is in any case valid as to the creditor who has accepted it. (n)**

### Payment by a third person who does not intend to be reimbursed.

Article 1238 "embodies the idea that no one should be compelled to accept the generosity of another." (Report of the Code Commission, p. 132.)

If the paying third person does not intend to be reimbursed the payment is deemed a donation which requires the debtor's consent to be valid. (see Art. 725.) However, if the creditor accepts the payment, it shall be valid as to him and the payor although the debtor did not give his consent to the donation.

EXAMPLE:

D owes C P1,000.00. Without the intention of being reimbursed, X paid D's obligation. D had previously accepted X's generosity.

In this case, D is not liable to X and his obligation to C is extinguished. But if D did not consent to the donation, X may recover from D since there has been no donation, although originally X did not intend to be reimbursed. Nevertheless, the obligation of D to C is extinguished because the payment is valid as to C who has accepted it.

Can D legally refuse to pay X and instead insist on paying C? No. (see Arts. 1236, par. 2; 1237.)

**ART. 1239. In obligations to give, payment made by one who does not have the free disposal of the thing due and capacity to alienate it shall not be valid, without prejudice to the provisions of Article 1427 under the Title on "Natural Obligations." (1160a)**

## Meaning of free disposal of thing due and capacity to alienate.

(1) *Free disposal of the thing due* means that the thing to be delivered must not be subject to any claim or lien or encumbrance of a third person.

(2) *Capacity to alienate* means that the person is not incapacitated to enter into contracts (Arts. 1327, 1329.) and for that matter, to make a disposition of the thing due.

## Free disposal of thing due and capacity to alienate required.

As a general rule, in obligations to give, payment by one who does not have the free disposition of the thing due or capacity to alienate it is not valid. This means that the thing paid can be recovered.

The exception is provided in Article 1427.[3] The creditor cannot be compelled to accept payment where the person paying has no capacity to make it.

[3]Art. 1427. When a minor between eighteen and twenty-one years of age, who has entered into a contract without the consent of the parent or guardian, voluntarily pays a sum of money or delivers a fungible thing in fulfillment of the obligation, there shall be no right to recover the same from the obligee who has spent or consumed it in good faith. (1160a)

**ART. 1240. Payment shall be made to the person in whose favor the obligation has been constituted, or his successor in interest, or any person authorized to receive it. (1162a)**

### Person to whom payment shall be made.

(1) Payment shall be made to:

(a) the creditor or obligee (person in whose favor the obligation has been constituted);

(b) his successor in interest (like an heir or assignee); or

(c) any person authorized to receive it.

(2) The creditor referred to must be the creditor at the time the payment is to be made not at the constitution of the obligation. Hence, if a person is subrogated to the right of the creditor, payment should be made to the new creditor. (Tuazon vs. Zamora & Sons, 2 Phil. 305 [1903].)

(3) When payment is made to the wrong party, the obligation is not extinguished as to the creditor who is without fault or negligence even if the debtor acted in outmost good faith and by mistake as to the person of the creditor or through error induced by fraud of a third person. (Cembrano vs. City of Butuan, 502 SCRA 494 [2006]; Allied Banking Corp. vs. Lim Sio Wan, 549 SCRA 504 [2008].)

### Meaning of "any person authorized to receive it."

As used in Article 1240, the phrase means not only a person authorized by the creditor, but also a person authorized by law to receive the payment, such as a guardian, executor or administrator of the estate of a deceased, and assignee or liquidator of a partnership or corporation as well as any other person who may be authorized to do so by law. (Haw Pia vs. China Banking Corporation, 80 Phil. 604 [1948].)

(1) Where payment has been made to an agent, aside from proving the existence of a special power of attorney, it is also necessary for evidence to be presented regarding the nature and extent of the alleged powers and authority granted to the agent. (Phil. National Bank vs. Court of Appeals, 256 SCRA 44 [1996].)

(2) Where payments were purportedly made to a "supervisor" of respondent company, who was clad in the company's uniform and drove a company's van, but the petitioner (payor) did not ascertain

the identity and authority of the said supervisor, nor did he ask to be shown any identification, relying solely on the man's representation that he was collecting payments for the respondent, the payments did not discharge petitioner's obligation to the respondent. (Culaba vs. Court of Appeals, 427 SCRA 721 [2004].)

(3) Where the charge invoice issued by X Corp., seller, clearly states that the buyer shall "make all checks payable to X Corp. only," but the buyer issued check payable to cash, which was received by X's sales representative who encashed the check but did not remit the money to X, the buyer's obligation to pay the purchase price is not extinguished. (Wee Sion Ben vs. Semexco/Zest-O Marketing Corp., 536 SCRA 615 [2007].)

(4) Where a contract of sale does not state that the purchase price should be paid by the buyer to a third party and the buyer failed to adduce any evidence that the owner had agreed, verbally or in writing, that the purchase price should be paid to the third party, it was held that the payment to the third party is not the payment that would extinguish the buyer's obligation to the seller. Such breach gives the seller a right to ask for specific performance or for annulment of the obligation to sell the property. (Montecillo vs. Reynes, 385 SCRA 244 [2002].)

Under Article 1242, payment in good faith to any person in possession of the credit, is valid although such person may not be authorized to receive the payment.

ILLUSTRATIVE CASES:

1. *Payment was made to a person not authorized by the seller to receive payment.*

*Facts:* B bought a certain electric plant from S. B paid C who was authorized by C to look for buyers of the plant. There was no evidence that C had authority to receive payment. S brought action to recover the price.

*Issue:* Is there valid payment to S?

*Held:* No. C was not duly authorized by S to receive payment. Where a person in making payment solely relied upon the representation of an agent as to his authority to receive payment, such payment is made at his own risk and where the agent was not so authorized, such payment is not a valid defense against the principal. (*Keeler Electric Co. vs. Rodriguez, 44 Phil. 20 [1922]*; Ormachea Tin Congco vs. Trillana, 13 Phil. 194 [1907].)

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2. *Payment was made to the widow of second marriage of deceased, after demand had been made by heirs of deceased by his first marriage.*

*Facts:* C was a creditor of D. The first wife of C died and C married again. After the death of C, the plaintiffs, children of C by his first marriage, demanded payment from D. D paid instead the widow of the second marriage of C.

*Issue:* Is there payment of the debt?

*Held:* No. The wife of the second marriage had no right whatever to receive the payment, especially so that a demand had already been made by the plaintiffs. D made an undue payment. *(Crisol vs. Claveron, [CA] 38 O.G. 3734.)*

**ART. 1241. Payment to a person who is incapacitated to administer his property shall be valid if he has kept the thing delivered, or insofar as the payment has been beneficial to him.**

**Payment made to a third person shall also be valid insofar as it has redounded to the benefit of the creditor. Such benefit to the creditor need not be proved in the following cases:**

**(1) If after the payment, the third person acquires the creditor's rights;**

**(2) If the creditor ratifies the payment to the third person;**

**(3) If by the creditor's conduct, the debtor has been led to believe that the third person had authority to receive the payment. (1163a)**

## Effect of payment to an incapacitated person.

Payment to a person incapacitated to administer or manage his property is not valid unless such incapacitated person kept the thing paid or delivered (so that it is not necessary that it should have been invested in some profitable venture) or was benefited by the payment. In the absence of this benefit, the debtor may be made to pay again by the creditor's guardian or by the incapacitated person himself when he acquires or recovers his capacity. Proof of such benefit is incumbent upon the debtor who paid.

Under Article 1240, payment should be made to his legal representative; if this is not possible, the debtor may relieve himself

from responsibility by the consignation in court of the thing or sum due. (Art. 1256, par. 1.)

**Effect of payment to a third person.**

Payment to a third person or wrong party is not valid except insofar as it has redounded to the benefit of the creditor. It is immaterial that the debtor acted in utmost good faith and by mistake as to the person of the creditor, or through error induced by fraud of a third person if the creditor is without fault or negligence. (Bank of the Phil. Islands vs. Court of Appeals, 232 SCRA 302 [1994].)

That the creditor was benefited by the payment made by the debtor to a third person is not presumed and must, therefore, be satisfactorily established by the person interested in proving this fact. In the absence of such proof, the payment thereof in error and in good faith will not deprive the creditor of his right to demand payment. (Panganiban vs. Cuevas, 7 Phil. 477 [1906].)

**When benefit to creditor need not be proved by debtor.**

The debtor is relieved from proving benefit to the creditor in case of:

(1) subrogation of the payer in the creditor's rights;

(2) ratification by the creditor; or

(3) estoppel on the part of the creditor. (par. 2.)

In such cases, the benefit to the creditor is to be presumed. Through *estoppel*, an admission or representation is rendered conclusive upon the person making it and cannot be denied or disproved as against the person relying thereon. (Art. 1431.)

Under the law, the debtor who, before having knowledge of the assignment of a credit to a third person, pays the original creditor, shall be released from the obligation. (Art. 1626.)

**ART. 1242. Payment made in good faith to any person in possession of the credit shall release the debtor. (1164)**

**Payment to third person in possession of credit.**

This article gives another instance when there is valid payment to a third person.

It must be observed that the "possession" referred to under the above provision is possession of the credit itself and not merely of the document or instrument evidencing the credit. Hence, mere possession of the instrument (unless transferable by delivery) does not entitle the holder to payment nor does payment release the debtor. Furthermore, the payer must act in good faith, that is, in the honest belief that he is making a valid payment and that the payee is the owner of the credit. Good faith, however, is presumed.

EXAMPLE:

D is indebted to C in the amount of P1,000.00 which indebtedness is evidenced by a promissory note signed by D in favor of C. C lost the promissory note which was later found by X who demanded payment from D.

Payment to X is not valid because X is the possessor merely of the document evidencing the credit and not of the credit itself.

If the promissory note is payable to bearer or holder (Negotiable Instruments Law [Act No. 2031], Sec. 9.) the obligation will be extinguished if D pays X in good faith.

Similarly, if the promissory note was indorsed by C to X, under a private agreement that X would not collect from D, payment by D in good faith to X will also extinguish the debt. It is immaterial that X acted in bad faith. The right of C will be against X.

ILLUSTRATIVE CASE:

*Property subject to right of repurchase was embargoed by the government and vendor a retro redeemed the property from said government and not from vendee a retro who subsequently sold the property.*

*Facts:* S sold in December 1897 to B a property with right of repurchase within six (6) months. S was not able to effect the repurchase in May 1898 by reason of the fact that S was absent from his place of residence on account of the war.

About that time, the revolution broke out and the property was seized by the revolutionary government from B. The property was redeemed by S from said government in November 1898. Subsequently, B sold the property to C. S brought action against C to recover the property.

*Issue:* Was the sale made by the revolutionary government to S valid with the result that B had no right to transfer to C the property in question?

*Held:* No. What S did was to attempt to reacquire the ownership of the property transferred to B from a third person to whom the property had not been transferred by B in any manner whatsoever. Therefore, the payment made by S to the revolutionary government which should have been made to B in order to redeem the property, could not have extinguished the obligation incurred by him in favor of the latter.

The revolutionary government was not in possession of the credit. A seizure or embargo is nothing but a prohibition enjoining the owner from disposing of his property. By the mere embargo of a property, the owner does not lose his title thereto. So that Article 1242 is not applicable to the case at bar. *(Panganiban vs. Cuevas, 7 Phil. 477 [1906].)*

**ART. 1243. Payment made to the creditor by the debtor after the latter has been judicially ordered to retain the debt shall not be valid. (1165)**

### When payment to creditor not valid.

In an action against the debtor who is the creditor of another, the latter (the debtor-stranger), during the pendency of the case, may be ordered by the court (or by any competent authority though it be administrative) to retain the debt until the right of the plaintiff, the creditor in the main litigation, is resolved. Payment made subsequently by the debtor-stranger shall not be valid if the plaintiff wins the case and cannot collect from the debtor to whom the payment is made. Such payment is considered as made in bad faith.

The benefit granted by Article 1243 can only be invoked by the creditor who secures the order of retention. (see 8 Manresa 284.)

### Garnishment of debtor's credit.

The proceeding for the purpose of subjecting a debtor's credit to the payment of his debt to another is known as *garnishment.* It is an attachment[4] by means of which the plaintiff seeks to subject to his

[4]It is a proceeding *in rem* and, in effect, means that the property attached is an indebted thing and a virtual condemnation of it to pay the owner's debt. The attaching creditor acquires a specific lien on the property attached which ripens into a judgment against the *res* when the order of sale is made. (Biñan Steel Corporation vs. Court of Appeals, 391 SCRA 90 [2002].) It involves money, stock, credits and other incorporeal property which belong to the party but is in the possession or under the control of a third person. Garnishment is thus a levy on personal property. (Caja vs. Nanquil, 438 SCRA 174 [2004]; see Solidum vs. Court of Appeals, 492 SCRA 261 [2007].)

claim the property of the defendant in the hands of a third person or money owed by such third person or garnishee to the defendant. (Manila Remnant Co., Inc. vs. Court of Appeals, 231 SCRA 281 [1994].)

Garnishment is in the nature of an involuntary novation by the substitution of one creditor for another. (see Art. 1291[2].)

> "It consists in the citation of some stranger to the litigation who is debtor to one of the parties to the action. By this means, such debtor-stranger becomes a forced intervenor; and the court, having acquired jurisdiction over his person by means of the citation, requires him to pay his debt, not to his former creditor, but to the new creditor who is creditor in the main litigation." (Tayabas Land Co. vs. Sharruf, 41 Phil. 382 [1921]; see Sec. 37, Rule 39; Secs. 7, 8, 10, 15, Rule 57, Rules of Court.)

**ART. 1244. The debtor of a thing cannot compel the creditor to receive a different one, although the latter may be of the same value as, or more valuable than that which is due.**

**In obligations to do or not to do, an act or forbearance cannot be substituted by another act or forbearance against the obligee's will. (1166a)**

### Very prestation due must be complied with.

(1) The first paragraph refers to a real obligation to deliver a specific thing. A thing different from that due cannot be offered or demanded against the will of the creditor or debtor, as the case may be.

(2) The second paragraph refers to personal (positive and negative) obligations. The act to be performed or the act prohibited cannot be substituted against the obligee's will. (see Art. 1167.)

### When prestation may be substituted.

Of course, substitution can be made if the obligee consents. In facultative obligations, the debtor is given the right to render another prestation in substitution. (Art. 1206.)

Article 1244 will not also apply in case of waiver by the creditor or substitution is allowed by stipulation with the consent of the creditor. (see Arts. 1245, 1291[1].)

**ART. 1245. Dation in payment, whereby property is alienated to the creditor in satisfaction of a debt in money, shall be governed by the law of sales. (n)**

### Special forms of payment.

There are four special forms of payment under the Civil Code, namely:

(1) dation in payment (Art. 1245.);

(2) application of payments (Art. 1253.);

(3) payment by cession (Art. 1255.); and

(4) tender of payment and consignation. (Arts. 1256-1261.)

Strictly speaking, application of payments is not a special form of payment.

### Meaning of dation in payment.

*Dation in payment (adjudication* or *dacion en pago)* is the conveyance of ownership of a thing by the debtor to creditor as an accepted equivalent of performance of a monetary obligation.

It is a special form of payment because it is not the ordinary way of extinguishing an obligation. A debt in money is satisfied, not by payment of money (Art. 1244.), but by the transmission of ownership of a thing by the debtor to the creditor.

### Requisites of dation in payment.

In order that there be a valid dation in payment, the following are the requisites:

(1) There must be performance of the prestation in lieu of payment *(animo solvendi)* which may consist in the delivery of a corporeal thing or a real right or a credit against a third person;

(2) There must be some difference between the prestation due and that which is given in substitution *(aliud pro alio)*; and

(3) There must be an agreement between the creditor and debtor that the obligation is immediately extinguished by reason of the performance of a prestation different from that due. (Lo vs. KJS Eco-Formwork System Phil., Inc., 413 SCRA 182 [2003]; Aquintey vs. Tibong, 511 SCRA 414 [2006].)

The undertaking really partakes in one sense of the nature of sale, that is, the creditor is really buying the thing or property of the debtor, payment for which is to be charged against the debtor's debt. As such, the vendor in good faith shall be responsible, for the existence and legality of the credit at the time of the sale but not for the solvency of the debtor, in specified circumstances.[5] (Lo vs. KJS Eco-Formwork System Phil., Inc., 413 SCRA 182 [2003].)

This mode of payment presupposes an existing debt which is extinguished to the extent of the value of the thing delivered or totally, if such is the intention of the parties. (Citizen Surety Ins. Co. vs. Court of Appeals, 162 SCRA 738 [1988]; Philippine Lawin Bus Co., Inc. vs. Court of Appeals, 374 SCRA 332 [2002].) It is an objective novation of the obligation. (see Art. 1291[1].)

EXAMPLE:

D owes C P15,000.00. To fulfill the obligation, D, with the consent of C, delivers a piano. If the piano, however, is worth less than P15,000.00, the conveyance must be deemed to extinguish the obligation to the extent only of the value of the piano as agreed or as may be proved, unless the parties have considered the piano by their agreement, express or implied, as full payment in which case the obligation of D is totally extinguished.

The conveyance is, in effect, a novation of the contract. (see Art. 1291[1].)

### Governing law.

The law of sales governs because dation in payment may be considered a specie of sale in which the amount of the money debt becomes the price of the thing alienated. (see Art. 1619.) As such, the essential elements of a contract (see Art. 1318.) must be present.

In its modern concept, what actually takes place in *dacion en pago* is an objective novation of the obligation (see Art. 1291[1].) where the thing offered as an accepted equivalent of the performance of an obligation is considered as the object of the contract of sale, while the debt is considered as the purchase price. In any case, common consent

[5]Art. 1628. The vendor in good faith shall be responsible for the existence and legality of the credit at the time of the sale, unless it should have been sold as doubtful; but not for the solvency of the debtor, unless it has been so expressly stipulated or unless the insolvency was prior to the sale and of common knowledge. xxx

is an essential prerequisite, be it sale or novation to have the effect of totally extinguishing the debt or obligation. (Filinvest Credit Corp. vs. Phil. Acetylene Co., Inc., 111 SCRA 421 [1982]; Vda. De Jayme vs. Court of Appeals, 390 SCRA 380 [2002].)

**Sale distinguished from dation in payment.**

The distinctions are the following:

(1) In sale, there is no pre-existing credit, while in dation in payment there is;

(2) In sale, obligations are created, while in dation in payment, obligations are extinguished;

(3) In sale, the cause is the price paid from the viewpoint of the seller, or the acquisition of the thing sold, from the viewpoint of the buyer, while in dation in payment, the extinguishment of the debt, from the viewpoint of the debtor, or the acquisition of the object in lieu of the credit, from the viewpoint of the creditor;

(4) In sale, there is more freedom in fixing the price than in dation in payment;

(5) In sale, the buyer has still to pay the price, while in dation in payment, the payment is received before the contract is perfected which is to be charged against the debtor's debt; and

(6) In sale, the parties deliver and receive the thing as seller and buyer, while in dation in payment, as debtor and creditor.

**Transmission of ownership to creditor.**

Dation in payment requires the delivery and transmission of ownership of a thing to the creditor who accepts it as equivalent of payment of an outstanding debt. Where the repossession of the thing was merely to secure the payment of the debtor's loan obligation and not for the purpose of transferring ownership thereof to the creditor in satisfaction said loan, no *dacion en pago* is accomplished. (Philippine National Bank vs. Pineda, 197 SCRA 1 [1991]; Fort Bonifacio Dev. Corp. vs. Yllas Lending Corp., 567 SCRA 454 [2008].)

Thus, an assignment by the mortgagor of her leasehold rights on a fishpond as security to guarantee the payment of the mortgage obligation is, in effect, a mortgage. Being but a security for the payment

of the loan, the assignment does not constitute dation in payment under Article 1245. (Development Bank of the Philippines vs. Court of Appeals, 284 SCRA 14 [1998].) Similarly, where the receipts signed by respondent (creditor) corporation's representative, show that the vehicles owned by petitioner company (debtor) were delivered to respondent in order that the latter would take custody for the purpose of selling the same as agent of petitioner whereby the proceeds thereof would be applied in payment of petitioner's indebtedness, such an agreement negates transfer of absolute ownership over the property to respondent, as in a sale. (Philippine Lawin Bus Co. vs. Court of Appeals, 374 SCRA 332 [2002].)

**ART. 1246. When the obligation consists in the delivery of an indeterminate or generic thing, whose quality and circumstances have not been stated, the creditor cannot demand a thing of superior quality. Neither can the debtor deliver a thing of inferior quality. The purpose of the obligation and other circumstances shall be taken into consideration. (1167a)**

### Rule of the medium quality.

If the obligation consists in the delivery of a specific thing, the very thing due must be delivered. (Art. 1244.) However, if the obligation is to deliver a generic thing, the purpose of the obligation and other circumstances shall be taken into consideration to determine the quality or kind of thing to be delivered.

Article 1246 is a principle of equity in that it supplies justice in cases where there is lack of precise declaration in the obligation of the quality or kind of thing to be delivered. It is always hard to find one thing that is exactly similar to another. If there is disagreement between the parties, the law steps in and determines whether the contract has been complied with or not according to the circumstances. (see 8 Manresa 280-281.)

The benefit of this article may be waived by the creditor by accepting a thing of inferior quality and by the debtor by delivering a thing of superior quality.

EXAMPLES:

S promised to deliver to B a horse. B cannot compel S to deliver a price-winning race horse. Neither can S require B to accept an old sickly horse.

(1) If B owns a stable of race horses and horse-racing is his main diversion in life, which fact is known to S, and the price agreed upon is the reasonable price of a race horse, then S must deliver a race horse.

(2) If B happens to be a *"calesa"* driver and B agreed to pay S for the horse an amount which is the reasonable price of a horse for *"calesa,"* then that kind of horse may be delivered.

(3) If B is a veterinary doctor and his only purpose in buying a horse is to examine its organs in connection with his work, this, and other relevant circumstances may show that the old sickly horse was intended by the parties to be delivered.

**ART. 1247. Unless it is otherwise stipulated, the extrajudicial expenses required by the payment shall be for the account of the debtor. With regard to judicial costs, the Rules of Court shall govern. (1168a)**

### Debtor paysfor extrajudicial expenses.

The extrajudicial expenses of payment are for the account of the debtor. The reason is that the obligation is extinguished when payment is made and it is, therefore, the debtor who is primarily benefited.

If the parties have made a stipulation as to who will bear the expenses, then their stipulation shall be followed.

Article 1247 does not apply to expenses incurred by the creditor in going to the debtor's domicile to collect. (Art. 1251.)

### Losing party generally pays judicial costs.

*Judicial costs* are the statutory amounts allowed to a party to an action for his expenses incurred in the action. Under the Rules of Court (Sec. 1, Rule 142.), the costs of an action shall, as a rule, be paid by the losing party. The court may, however, for special reasons, adjudge that either party shall pay the costs, or that the same be divided, as may be equitable.

No costs are allowed against the Government, unless otherwise provided by law.

**ART. 1248. Unless there is an express stipulation to that effect, the creditor cannot be compelled partially to receive the prestations in which the obligation consists. Neither may the debtor be required to make partial payments.**

**However, when the debt is in part liquidated and in part unliquidated, the creditor may demand and the debtor may effect the payment of the former without waiting for the liquidation of the latter. (1169a)**

### Complete performance of obligation necessary.

The above provision contemplates obligations where there is only one creditor and only one debtor. Joint and several obligations are governed by Articles 1207 to 1222. (Chap. 3.) The prestation, *i.e.,* the object of the obligation, must be performed in one act, not in parts. (Barons Marketing Corp. vs. Court of Appeals, 286 SCRA 76 [1998].)

In order that payment may extinguish an obligation, it is necessary that there be complete performance of the prestation. (Art. 1233.) The creditor may accept but he cannot be compelled to accept partial payment or performance. The debtor has the duty to comply with the whole of the obligation but he cannot be required to make partial payments if he does not wish to do so.

### When partial performance of obligation allowed.

There are cases, however, when partial performance may be either required or insisted. Among these cases are:

(1) when there is an express stipulation to that effect (par. 1.);

(2) when the debt is in part liquidated (definitely determined or determinable) and in part unliquidated (par. 2.);

(3) when the different prestations in which the obligation consists are subject to different terms or conditions which affect some of them. (8 Manresa 288.) In obligations which comprehend several distinct prestations (*e.g.*, obligation to pay debt in installments.), it is evident that the prestations need not be executed simultaneously but each successive execution thereof must be complete;

(4) when the parties know that the obligation reasonably cannot be expected to be performed completely at one time; and

(5) when there is abuse of right or if good faith requires acceptance.

EXAMPLES:

(1) D is indebted to C for P5,000.00 due today. D cannot compel C to receive P4,000.00 in partial payment of the obligation and neither can

C require D to pay only P4,000.00 unless there is an agreement to the contrary.

(2) If D owes C P5,000.00 plus the share of C from the profit of a business which, however, has not yet been liquidated or determined, C may demand and D may effect, the payment of the P5,000.00 which is already known.

(3) If P4,000.00 of the debt of D is due today and P1,000.00 tomorrow, the obligation can be complied with partially. Similarly, partial performance may be effected in case the payment of the P1,000.00 is subject to the fulfillment of a condition.

(4) S obliged himself to deliver 50,000 bags of cement to B at the construction site of a building. S makes a first delivery of 5,000 bags, informing B that continuous deliveries will follow. In this case, B cannot, in good faith, refuse to accept the partial deliveries as long as they are sufficient for his construction needs.

ILLUSTRATIVE CASE:

*Debtor claims that creditor abused its rights when it rejected the former's offer of settlement of its outstanding obligations and subsequently filed the action for collection.*

*Facts:* Respondent (plaintiff) company, PDP, appointed petitioner (defendant) BMC as one of the dealers of electrical wires and cables. As such dealer, BMC was given by PDP 60 days credit for its purchases of electrical products. The credit term was to be reckoned from the date of delivery by PDP of its products to defendant.

On several occasions, PDP wrote BMC demanding payments of its outstanding obligations due PDP. PDP rejected BMC's offer to pay its outstanding account in monthly installments of P500,000.00 plus 1% interest per month until full payment, and reiterated its demand for the full payment of defendant's account.

PDP filed a complaint against BMC for the recovery of P3,802,478.20 representing the value of the wires and cables the former had delivered to the latter, including interest. It likewise prayed that it be awarded attorney's fees at the rate of 25% of the amount demanded, exemplary damages amounting to at least P100,000.00, the expenses of litigation, and the costs of suit.

Petitioner in its answer, admitted purchasing the wires and cables from private respondent but disputed the amount claimed by the latter. Petitioner likewise interposed a counterclaim against private respondent, alleging that it suffered injury to its reputation due to latter's acts. Such

acts were purportedly calculated to humiliate petitioner and constituted an abuse of rights.

*Issues:* The instant petition raises two issues one of which is whether or not PDP is guilty of abuse of right.

*Held:* (1) *Limitation of abuse of right.* — The right of the creditor under Article 1248 has its limitations. "Since the creditor cannot be compelled to accept partial performance, unless otherwise stipulated, the creditor who refuses to accept partial prestations does not incur in delay or *mora accipiendi,* except when there is abuse of right or if good faith requires acceptance. (citing IV Tolentino, Commentaries and Jurisprudence on the Civil Code of the Phils., 1990 Ed., p. 298.)

Indeed, the law, as set forth in Article 19 of the Civil Code, prescribes a "primordial limitation on all rights" by setting certain standards that must be observed in the exercise thereof. Thus:

> 'Art. 19. Every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith.'

Petitioner invokes Article 19 and Article 21[6] of the Civil Code claiming that private respondent abused its rights when it rejected petitioner's offer of settlement and subsequently filed the action for collection. It asks that the Court that it be allowed to liquidate its obligation to private respondent, without interests, in eight (8) equal monthly installments.

Both parties agree that to constitute an abuse of rights under Article 19, the defendant must act with bad faith or intent to prejudice the plaintiff. They cite the following comments of Tolentino as their authority:

> *'Test of Abuse of Right.* — Modern jurisprudence does not permit acts which, although not unlawful, are anti-social. *There is undoubtedly an abuse of right when it is exercised for the only purpose of prejudicing or injuring another.* When the objective of the actor is illegitimate, the illicit act cannot be concealed under the guise of exercising a right. The principle does not permit acts which, without utility or legitimate purpose, cause damage to another, because they violate the concept of social solidarity which considers law as rational and just. Hence, every abnormal exercise of a right, contrary to its socio-economic purpose, is an abuse that will give rise to liability.
>
> *The exercise of a right must be in accordance with the purpose for which it was established, and must not be excessive or unduly harsh; there must be no intention to injure another.* Ultimately, however, and in

[6]Art. 21. Any person who willfully causes loss or injury to another in a manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage.

practice, courts, in the sound exercise of their discretion, will have to determine all the facts and circumstances when the exercise of a right is unjust, or when there has been an abuse of right.' (citing, I Tolentino, pp. 61-62.)"

(2) *Good faith presumed.* — "The question therefore, is whether private respondent intended to prejudice or injure petitioner when it rejected petitioner's offer and filed the action for collection.

We hold in the negative. It is an elementary rule in this jurisdiction that good faith is presumed and that the burden of proving bad faith rests upon the party alleging the same. In the case at bar, petitioner has failed to prove bad faith on the part of private respondent. Petitioner's allegation that private respondent was motivated by a desire to terminate its agency relationship with petitioner so that private respondent itself may deal directly with Meralco is simply not supported by the evidence. At most, such supposition is merely speculative."

(3) *Rejection of offer based on very legitimate reasons.* — "Moreover, we find that private respondent was driven by very legitimate reasons for rejecting petitioner's offer and instituting the action for collection before the trial court. As pointed out by private respondent, the corporation had its own 'cash position to protect in order for it to pay its own obligations.' This is not such 'a lame and poor rationalization' as petitioner purports it to be. For if private respondent were to be required to accept petitioner's offer, there would be no reason for the latter to reject similar offers from its other debtors. Clearly, this would be inimical to the interests of any enterprise, especially a profit-oriented one like private respondent. It is plain to see that what we have here is a mere *exercise* of rights, not an *abuse* thereof.

Under these circumstances, we do not deem private respondent to have acted in a manner contrary to morals, good customs or public policy as to violate the provisions of Article 21 of the Civil Code."

(4) *Petitioner not entitled to moral and exemplary damages.* — "Consequently, petitioner's prayer for moral and exemplary damages must thus be rejected. Petitioner's claim for moral damages is anchored on Article 2219(10) of the Civil Code which states:

'ART. 2219. Moral damages may be recovered in the following and analogous cases:

x x x.

(10) Acts and actions referred to in Articles 21, 26, 27, 28, 29, 30, 32, 34, and 35.

x x x.'

Having ruled that private respondent's acts did not transgress the provisions of Article 21, petitioner cannot be entitled to moral damages or, for that matter, exemplary damages. While the amount of exemplary damages need not be proved, petitioner must show that he is entitled to *moral,* temperate or compensatory damages before the court may consider the question of whether or not exemplary damages should be awarded. As we have observed above, petitioner has failed to discharge this burden."

(5) *Contract has force of law.* — "It may not be amiss to state that petitioner's contract with private respondent has the force of law between them. Petitioner is thus bound to fulfill what has been expressly stipulated therein."

(6) *Partial performance of obligation not allowed.* — "In the absence of any abuse of right, private respondent cannot be allowed to perform its obligation under such contract in parts. Otherwise, private respondent's right under Article 1248 will be negated, the sanctity of its contract with petitioner defiled. The principle of autonomy of contracts must be respected." *(Barons Marketing Corp. vs. Court of Appeals, 286 SCRA 96 [1998].)*

**ART. 1249. The payment of debts in money shall be made in the currency stipulated, and if it is not possible to deliver such currency, then in the currency which is legal tender in the Philippines.**

**The delivery of promissory notes payable to order, or bills of exchange or other mercantile documents shall produce the effect of payment only when they have been cashed, or when through the fault of the creditor they have been impaired.**

**In the meantime, the action derived from the original obligation shall be held in abeyance. (1170)**

## Payment of debts in money payable in Philippine currency.

The first paragraph of Article 1249 is not applicable where the contract between the parties is to pay in Philippine currency. (Haw Pia vs. China Banking Corp., 80 Phil. 604 [1948].) The phrase "currency stipulated" used in Article 1249 refers to money different from that which is the legal tender or legally current in the Philippines. (see Del Rosario vs. Sandico, 85 Phil. 170 [1949].)

The first paragraph of the above article was modified by Republic Act No. 529 which took effect on June 16, 1950. *(infra.)* This law requires the payment of domestic obligations in money in Philippine

currency and declares as "against public policy, and null and void, and of no effect" any provision in a contract or agreement requiring the payment of such obligations in a currency other than Philippine currency. The obligation itself is not declared void. The void provision does not defeat a creditor's claim for payment in Philippine currency, as it is provided in Section 1 of the Act that such obligation "shall be discharged upon payment in any coin or currency which at the time of payment is legal tender for public and private debts." A contrary rule would allow a person to profit or enrich himself inequitably at another's expense. (Ponce vs. Court of Appeals, 90 SCRA 535 [1979]; San Buenaventura vs. Court of Appeals, 181 SCRA 197 [1990]; Republic Resources Dev't. Corp. vs. Court of Appeals, 203 SCRA 164 [1991].)

*Note:* R.A. No. 529 was repealed by R.A. No. 8183, approved on June 11, 1996. There is no longer any legal impediment to having obligations or transactions paid in a foreign currency as long as the parties agree to such arrangement. (Development Bank of the Phils. vs. Court of Appeals, 494 SCRA 25 [2006].)

### Meaning of legal tender.

*Legal tender* is that currency which a debtor can legally compel a creditor to accept in payment of a debt in money when tendered by the debtor in the right amount.[7] (see Black's Law Dictionary.)

### Legal tender in the Philippines.

In the Philippines, all coins and notes issued by the *Bangko Sentral ng Pilipinas* constitute legal tender for all debts, both public or private. Unless otherwise fixed by its Monetary Board, coins are legal tender for amounts not exceeding P50.00 for denominations of P0.25 and above, and in amounts not exceeding P20.00, for denominations of P0.10 or less. (Sec. 52, R.A. No. 7653.)

All coins and bills above P1.00 are, therefore, valid legal tenders for any amount.[8]

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[7]As to validity of payments of pre-war obligations made in Japanese war notes and the rules *re* payment after the war of obligations incurred during the Japanese occupation, see Hilado vs. De la Costa, 83 Phil. 471 (1949); Haw Pia vs. China Banking Corp., 80 Phil. 602 (1948); Phil Trust Co. vs. Araneta, 83 Phil. 132 (1949); Larroza and Enterezo vs. Bañez, 84 Phil. 354 (1969); Gomez vs. Tabia, 84 Phil. 269 (1949); Roño vs. Gomez, 83 Phil. 890 (1949).

[8]Under BSP Circular No. 537 (July 18, 2006) which took effect on August 11, 2006, the maximum amount of coins to be considered legal is adjusted as follows: (1) P1,000.00 for denominations P1.00, P5.00, and P10.00 coins, and (2) P100.00 for denominations of P.01, P.05, P.10 and P.25 coins.

**Payment by means of instruments of credits.**

(1) *Right of creditor to refuse or accept.* — Promissory notes, checks, bills of exchange and other commercial documents are not legal tender and, therefore, the creditor cannot be compelled to accept them. This is true even though the check is certified (see Negotiable Instruments Law [Act No. 2031], Sec. 189.), or is a manager's check. (Cuaycong vs. Ruiz, 80 Phil. 170 [1948]; De Legarda vs. Miailhe, 88 Phil. 637 [1951]; Far East Bank and Trust Company vs. Diaz Realty, Inc., 363 SCRA 659 [2001].)

(a) The creditor, if he chooses, may accept them, without the acceptance producing the effect of payment. In the meantime, the demandability of the original obligation is suspended until the payment by the commercial document is actually realized. The creditor must cash the instrument, and it is only when it is dishonored, that he can bring an action for non-payment of the debt. (par. 3.)

(b) The Civil Code provisions on payment of obligations, particularly Article 1245, are applicable where what is involved is the payment of a judgment obligation. (Biana vs. Gimenez, 469 SCRA 486 [2005].)

(2) *Payment for purpose of redemption.* — "A redemption of property sold under execution is not rendered invalid by reason of the fact that the payment to the sheriff for the purpose of redemption is effected by means of a check for the amount due." (Javellana vs. Mirasol, 40 Phil. 761 [1919].)

Article 1249 deals with a mode of extinction of debts, while the right to redeem is not an obligation but the exercise of a right; nor is it intended to discharge a pre-existing debt. It is the policy of the law to be liberal in redemption cases, to aid rather than to defeat the right of redemption. (Fortunato vs. Court of Appeals, 196 SCRA 269 [1991].) Accordingly, the Civil Code provisions on payment of obligations may not be applied where what applies is the settled rule that a mere tender of a checks is sufficient to compel redemption.

(3) *Effect on obligation.* — Payment by means of mercantile documents does not extinguish the obligation —

(a) until they have been cashed (see Crystal vs. Court of Appeals, 62 SCRA 501 [1975].); or

(b) unless they have been impaired through the fault of the creditor. (par. 2.)

In other words, the delivery of the paper or document shall produce the effect of a valid payment only when either situation has taken place. In the first case, the instrument may have been executed by the debtor himself or by a third person. The second case is applicable only where the instrument was executed by a third person.

**Applicability of impairment clause of Article 1249.**

Article 1249 (par. 2.) is applicable not only to those instruments executed by third persons, which the debtor delivers to the creditor, but also to a note executed by the debtor himself and delivered to the creditor. (Cia Gen. De Tabacos vs. Molina, 5 Phil. 142 [1905].)

It has been held, however, that the clause relative to impairment of the negotiable character of commercial paper by the fault of the creditor is applicable only to the first class of instruments, *i.e.*, those executed by third persons and delivered by the debtor to the creditor, and does not apply to instruments executed by the debtor himself and delivered to the creditor. (National Marketing Corp. vs. Federation of United Namarco Distributors, Inc., 49 SCRA 238 [1973].)

Acceptance of a check implies an undertaking of due diligence on the part of the payee in presenting it for payment. If no such presentment was made, the drawer cannot be held liable irrespective of loss or injury sustained by the payee. (Papa vs. A.U. Valencia, 284 SCRA 643 [1998]; see Pio Barretto Dev. Corp. vs. Court of Appeals, 360 SCRA 127 [2001].)

ILLUSTRATIVE CASES:

1. *Creditor neglected to have a bill of exchange protested as required by law for non-payment by the drawee.*

*Facts:* S sold goods to B for P2,200.00. For the purpose of paying the sum, B delivered to S a bill of exchange for P2,700.00 purporting to be drawn by C to the order of D on E. When the bill was delivered to S it was indorsed by D, and apparently accepted by E. S took the bill and paid B P500.00 in cash, the difference between P2,700.00 and P2,200.00, the value of the goods sold.

E refused to pay the bill on the ground that his signature thereto was a forgery. S neglected to have the bill of exchange protested for non-payment. Nothing was ever realized on the bill.

*Issue:* Is B liable for the full value of the goods sold?

*Held:* No. Where a bill of exchange is delivered by the debtor to the creditor and the drawee (the addressee of a bill of exchange, that is, the person who is commanded or ordered by the drawer to pay.) of the bill refused to make payment and the creditor neglected to have the bill protested for non-payment as required by law, the delivery of the bill by the debtor to the creditor operates as a valid payment and he must suffer the loss occasioned by its nonpayment. The sum of P2,200.00 was deducted from the sum allowed S. (*Quiros vs. Tan Guinlay, 5 Phil. 675 [1906]*; see U.S. vs. Beduya, 14 Phil. 397 [1906].)

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2. *Seller accepted (PNB) letters of credit merely to insure payment of goods by buyer who claimed that the failure of seller to present to buyer for his acceptance the sight drafts drawn under and as required by the letters discharged him of his debt.*

*Facts:* N (Namarco) and F entered into a contract of sale whereby F agreed to pay N on cash basis certain merchandise to be imported by N upon delivery of the duly indorsed negotiable shipping document covering the same.

To insure the payment of the goods by F, N accepted three (3) PNB (Phil. National Bank) domestic letters of credit in favor of N for the account of F, available by sight drafts covering the full invoice value of the goods. After N had delivered a great portion of the goods listed in the contract, it refused to deliver the other goods. The common condition of the three (3) letters of credit is that the sight drafts drawn on them must be duly accepted by F. Although PNB informed N that the former could not negotiate and effect payment on the sight drafts drawn under its letters of credit as the requirements covering the same had not been complied with, said drafts were not presented by N to F for acceptance.

N brought action to recover the cost of the merchandise. The theory of F is that the failure of N to present the sight drafts to the former for acceptance deprives N of a cause of action against F.

*Issue:* Did the delivery of the domestic letters of credit to N operate to discharge the debt of F?

*Held:* No. N's action is not based on the letters of credit but on its legal right to the cost of the goods delivered. N accepted the letters "to insure the payment of the goods by F." It was given, therefore, as a mere guarantee for the payment of the merchandise.

The delivery of promissory notes payable to order, or bills of exchange, etc., shall produce the effect of payment only when realized,

or when by the fault of the creditor, the privileges inherent in their negotiable character have been impaired. The claim in Article 1249 relative to impairment of the negotiable character of the commercial paper is applicable only to instruments executed by third persons and delivered by the debtor to the creditor, and does not apply to instruments executed by the debtor himself and delivered to the creditor.

In the case at bar, it is not even pretended that the negotiable character of the sight draft was impaired as a result of the fault of N. There was no agreement that they should be accepted as payment. A mere attempt to collect or enforce a bill or note from which no payment results is not such an appropriation of it as to discharge the debt. *(National Marketing Corp. vs. Federation of United Namarco Distributors, Inc., supra.)*

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3. *When payment by check cannot be refused to effect a repurchase.*

*Facts:* B told S, etc. that he (B) would accept the repurchase by S, etc., of a certain land by check and that by reason of such repurchase, S, etc., could return to their home. The following day S, etc., offered payment by check.

*Issue:* Has B the right to refuse to accept such payment?

*Held:* No. B is guilty of estoppel (see Art. 1431.) because he induced S, etc., to act upon the belief that he had consented to said manner of payment. *(Gutierrez vs. Carpio, 53 Phil. 334 [1929].)*

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4. *Seller did not encash the check for more than 10 years, contending that by reason thereof, no sale was consummated.*

*Facts:* Petitioner MP, acting as attorney-in-fact of the late AMB sold to respondent FP, a parcel of land. FP had given MP the amounts of P5,000 in cash on May 24, 1973 and P40,000 in check on June 16, 1973 in payment of the purchase price of the subject lot.

MP, while admitting having received only P5,000 and issued receipts for both amounts, asserts that he never encashed the aforesaid check and, therefore, the sale was not consummated. There was no evidence at all that MP did not, in fact, encash said check. On the other hand, respondent FP testified in court that petitioner MP had received the amount of P45,000.00 and issued receipts therefor. According to respondent court, the presumption is that the check was encashed, especially since the payment by check was not denied by defendant-appellant (herein petitioner) who, in his Answer, merely alleged that he "can no longer recall the transaction which is supposed to have happened 10 years ago."

MP contends that such a conclusion is based on the erroneous presumption that the check (in the amount of P40,000.00) had been cashed, citing Art. 1249 of the Civil Code, which provides, in part, that payment by checks shall produce the effect of payment only when they have been cashed or when through the fault of the creditor they have been impaired. He insists that he never cashed said check; and, such being the case, its delivery never produced the effect of payment.

While admitting that he had issued receipts for the payments, he asserts that said receipts, particularly the receipt of the check in the amount of P40,000.00, do not prove payment. He avers that there must be a showing that said check had been encashed. If, according to petitioner, the check had been encashed, respondent FP should have presented the check duly stamped received by the payee, or at least its microfilm copy.

*Issue:* Was there a consummation of the sale of the subject property?

*Held:* Yes. (1) *Presumption is that check had been cashed.* — "Petitioner's assertion that he never encashed the aforesaid check is not substantiated and is at odds with his statement in his answer that "he can no longer recall the transaction which is supposed to have happened 10 years ago." After more than ten (10) years from the payment in part by cash and in part by check, the presumption is that the check had been encashed. As already stated, he even waived the presentation of oral evidence."

(2) *Petitioner's fault resulted in the impairment of check.* — "Granting that petitioner had never encashed the check, his failure to do so for more than ten (10) years undoubtedly resulted in the impairment of the check through his unreasonable and unexplained delay.

While it is true that the delivery of a check produces the effect of payment only when it is cashed, pursuant to Art. 1249 of the Civil Code, the rule is otherwise if the debtor is prejudiced by the creditor's unreasonable delay in presentment. The acceptance of a check implies an undertaking of due diligence in presenting it for payment, and if he, from whom it is received, sustains loss by want of such diligence, it will be held to operate as actual payment of the debt or obligation for which it was given.

It has, likewise, been held that if no presentment is made at all, the drawer cannot be held liable irrespective of loss or injury unless presentment is otherwise excused. This is in harmony with Article 1249 of the Civil Code under which payment by way of check or other negotiable instrument is conditioned on its being cashed, except when through the fault of the creditor, the instrument is impaired. The payee of a check would be a creditor under this provision and if its non-payment is caused by his negligence, payment will be deemed effected and the

obligation for which the check was given as conditional payment will be discharged. *(Papa vs. A.U. Valencia and Co., Inc., 284 SCRA 643 [1998].)*

**ART. 1250. In case an extraordinary inflation or deflation of the currency stipulated should supervene, the value of the currency at the time of the establishment of the obligation shall be the basis of payment, unless there is an agreement to the contrary. (n)**

### Meaning of inflation and deflation.

(1) *Inflation* is a sharp sudden increase of money or credit or both without a corresponding increase in business transactions. (Webster's Dictionary.) Inflation causes a drop in the value of money, resulting in rise of the general price level.

There is inflation when there is an increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level. (Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999], citing Paras, Civil Code of the Phils., Annotated [1994], Vol. IV, p. 394; see Citibank, N.A. vs. Sabeniano, 514 SCRA 441 [2007].)

(2) *Deflation* is the reduction in volume and circulation of the available money or credit, resulting in a decline of the general price level; it is the opposite of inflation.

For lack of an express provision on the question in the old Civil Code, there was a great deal of uncertainty and confusion as a result of contracts entered into during the last world war which saw an extraordinary inflation of currency. According to the Code Commission, the rule in Article 1250 provides a just solution for future cases. (see Report of the Code Commission, pp. 132-133.)

### Requisites for application of Article 1250.

The following requisites must be proven:

(1) There is an official declaration of extraordinary inflation or deflation from the *Bangko Sentral ng Pilipinas* (BSP).

(2) The obligation is contractual in nature; and

(3) The parties expressly agreed to consider the effects of the extraordinary inflation or deflation. (see Equitable PCI Bank vs. Sheung Ngor, 541 SCRA 223 [2007].)

A contractual agreement is needed for the effects of extraordinary inflation to be taken into account to alter the value of the currency. (Nepomuceno vs. City of Surigao, 560 SCRA 41 [2008].)

From the employment of the words "extraordinary inflation or deflation of the currency *stipulated,"* it can be seen that the legal rule in Article 1250 envisages *contractual* obligations where a currency is selected by the parties as the medium of payment. Hence, it is applicable only to cases where a contract or agreement is involved. More importantly, the parties must agree to recognize the effects of extraordinary inflation or deflation, as the case may be.

The Article does not apply where the obligation to pay arises from other sources independent of contract, such as law, quasi-contract, tort, or crime. The taking of private property by the government in the exercise of its power of eminent domain does not give rise to a contractual obligation. (Comm. of Public Highways vs. Burgos, 96 SCRA 831 [1980].)

**Basis of payment in case of extraordinary inflation or deflation.**

Under Article 1250, the purchasing value of the currency at the time of the establishment of the obligation shall be the basis of payment, in case of any extraordinary increase or decrease in the purchasing power of the currency which the parties could not have reasonably foreseen. This is, however, subject to the agreement of the parties to the contrary.

The burden of proving that there had been extraordinary inflation or deflation of the currency is upon the party that alleges it.

EXAMPLE:

D borrowed from C P5,000.00 payable after five (5) years. On the maturity of the obligation, the value of P5,000.00 dropped to P2,500.00 because of inflation (or increased to P10,000.00 because of deflation).

In this case (assuming there is extraordinary inflation or deflation), the basis of payment shall be the equivalent value of the currency today to that five (5) years ago. Hence, D is liable to pay B P10,000.00 (or P2,500.00) unless there is an agreement to the contrary, *e.g.*, that D shall pay C P5,000.00 regardless of any extraordinary decrease or increase in the purchasing power of the peso.

*Note:* The provision of Article 1250 requires for its application a declaration of inflation or deflation by the Central Bank. Without such declaration, creditors cannot demand an increase, and debtors, a decrease of what is due to or from them. (see Ramos vs. Court of Appeals, 275 SCRA 167 [1997].)

ILLUSTRATIVE CASE:

*Fixing of the rate of exchange between the peso and the dollar by law or by authority of law.*

*Facts:* Under the collective bargaining agreement between Pan Am Airways and PAA Employees' Association, the parties agreed to re-negotiate on wage rates (1) if during the term of the agreement a law be passed diminishing the value of the Philippine Currency and (2) as a result thereof Pan Am is granted the necessary authority to increase its rates. No law had been passed by Congress diminishing the value of the Philippine Currency.

Pursuant to law (R.A. No. 2609; Sec. 79, R.A. No. 265.), and during the life of the agreement, the Central Bank of the Philippines fixed the rate of exchange between the peso and the dollar at P3.20 to $1.00 and later to P3.00 to $1.00 and authorized the sale of airline tickets at the rate of P3.20 to $1.00.[9] The (defunct) Court of Industrial Relations found the two conditions in the agreement present and reopened the said agreement for negotiation on wage rates.

*Issue:* Do the fixing of the rate of exchange between the peso and the dollar and the authority to sell airline tickets referred to amount to a law diminishing the value of the currency?

*Held:* Yes. The purchasing power or value of money or currency does not depend upon, cannot come into being, be created or brought about by a law enacted by the legislative department of the Government. If by law or treaty the rate of exchange between two currencies should be fixed or stipulated, such law or treaty could not give the money or currency the purchasing power or value fixed or stipulated but would bind the Government enacting the law or contracting parties to a treaty to pay or supply the difference between the value fixed or stipulated and the real value of the currency should the latter be lower than the fixed or stipulated rate of exchange between the two currencies by drawing upon its international reserves.

[9]The prior conversion rate was P2.00 to $1.00. For definition of "par value" and "rate of exchange" of currency and distinction between the two, see Manuel & Co., Inc. vs. Central Bank, 38 SCRA 533 (1971).

To prevent depletion of its reserve the Government could impose restrictions to discourage payment at the value fixed or rate of exchange stipulated which would drain its reserve. So that when the parties agreed to negotiate on wage rates during the term of the agreement, should a law be passed diminishing the value of the currency, they did not literally mean a law enacted by Congress which, as already explained, would not really diminish the purchasing power or value of the currency but would just confirm the real value or actual purchasing power of the currency.

The adherence to the letter of the collective bargaining agreement was not the intent of the contracting parties when they entered into it. *(Pan American World Airways vs. PAA Employees' Association, 10 SCRA 21 [1964].)*

**When inflation or deflation extraordinary.**

Article 1250 was inserted in the Civil Code to abate the uncertainty and confusion that affected contracts entered into or payments made during World War II, and to help provide a just solution to future cases. The supervening of extraordinary inflation or deflation is never assumed. The party alleging it must lay down the factual basis for the application of Article 1250. (Singson vs. Caltex [Philippines], Inc., 342 SCRA 91 [2000].)

As to what would constitute an extraordinary inflation or deflation of currency, the Code does not specifically define. The word "extraordinary" is, however, used in other articles. Thus, Article 1680 (in connection with leases of rural lands) speaks of "extraordinary fortuitous events" to be "fire, war, pestilence, unusual flood, locusts, earthquake, or others which are uncommon, and which the contracting parties could not have reasonably foreseen." Article 576 (in connection with the rights of the usufructuary) also makes reference to "calamity or extraordinary event."

It has been suggested that a better test as to when inflation or deflation is extraordinary is "one that neither party had reason to foresee when the obligation was established" or "manifestly beyond the contemplation of the parties" at the time of the establishment of the obligation as stated in Article 1267 *(infra.)* or a similar case. (Justice J.B.L. Reyes, Observations on the New Civil Code, XVI L.J., p. 48, Jan. 31, 1951.)

In a case, the plaintiff sought on February 18, 1971, an adjustment of the money judgment rendered in its favor on November 23, 1967 due

to the alleged supervening extraordinary inflation of the Philippine peso which has reduced the value of the bonds paid by the defendant to the plaintiff. The Supreme Court ruled "that while there has been a decline in the purchasing power of the Philippine peso, this downward fall of the currency cannot be considered extraordinary. It is simply a universal trend that has not spared our country."

Extraordinary inflation or deflation is said to exist where there is an unimaginable increase or decrease in the purchasing power of the Philippine currency, or fluctuation in the value of pesos which could not have been reasonably foreseen or was manifestly beyond the contemplation of the parties at the time of the establishment of the obligation. (Singson vs. Caltex [Phils.], Inc., 342 SCRA 91 [2000]; Serra vs. Court of Appeals, 229 SCRA 60 [1994]; Filipino Pipe & Foundry Corp. vs. NAWASA, 161 SCRA 32 [1988]; Songrador vs. Valderama, 168 SCRA 215 [1988]; Singson vs. Caltex [Philippines], Inc., *supra*.; Almeda vs. Bathala Marketing Industries, Inc., 542 SCRA 470 [2008].)

ILLUSTRATIVE CASE:

*The judgment award for demurrage charges was recomputed as of the date of payment, applying Article 1250.*

*Facts:* The goods subject of counterclaim of petitioner, TB & Sons, were loaded for shipment on vessels of respondent, US Lines, Inc. Petitioner claimed that respondent violated its contractual obligation to deliver, when instead of delivering the goods to petitioner as consignee thereof, respondent deposited the same in bonded warehouses, stripped of their contents with the prior authorization of the Bureau of Customs. It appears that petitioner was at fault for not taking delivery of its cargo from the container vans within the 10-day free demurrage period, an inaction which led respondent to deposit the same in bonded warehouses.

The trial court found petitioner liable to respondent for demurrage incurred in the amount of P99,408.00 plus interest and attorney's fees "all of which shall be recomputed as of the date of payment, in accordance with the provisions of Article 1250 of the Civil Code." The Court of Appeals affirmed *in toto* the judgment of the trial court.

In calling for the application of Article 1250, respondent urged that judicial notice be taken of the succeeding devaluations of the peso *vis-à-vis* the US dollar since the time the proceedings began in 1981. According to respondent, the computation of the amount thus due from the petitioner should factor in such peso devaluations.

*Issue:* Did the Court of Appeals err in affirming the trial court's decision which recomputed the judgment award as of the date of payment?

*Held:* (1) *When extraordinary inflation or deflation exists.* — "Extraordinary inflation or deflation, as the case may be, exists when there is an unusual increase or decrease in the purchasing power of the Philippine peso which is beyond the common fluctuation in the value of said currency, and such increase or decrease could not have been reasonably foreseen or was manifestly beyond the contemplation of the parties at the time of the establishment of the obligation. Extraordinary inflation can never be assumed; he who alleges the existence of such phenomenon must prove the same.

The Court holds that there has been no extraordinary inflation within the meaning of Article 1250 of the Civil Code. Accordingly, there is no plausible reason for ordering the payment of an obligation in an amount different from what has been agreed upon because of the purported supervention of extraordinary inflation."

(2) *Occurrence of extraordinary inflation has not been proved.* — "As it were, respondent was unable to prove the occurrence of extraordinary inflation since it filed its complaint in 1981. Indeed, the record is bereft of any evidence, documentary or testimonial, that inflation, nay, an extraordinary one, existed. Even if the price index of goods and services may have risen during the intervening period, this increase, without more, cannot be considered as resulting to 'extraordinary inflation' as to justify the application of Article 1250. The erosion of the value of the Philippine peso in the past three or four decades, starting in the mid-sixties, is, as the Court observed in Singson vs. Caltex (Phil.), Inc., characteristics of most currencies. And while the Court may take judicial notice of the decline in the purchasing power of the Philippine currency in that span of time, such downward trend of the peso cannot be considered as the extraordinary phenomenon contemplated by Article 1250 of the Civil Code. Furthermore, absent an official pronouncement or declaration by competent authorities of the existence of extraordinary inflation during a given period, as here, the effects of extraordinary inflation, if that be the case, are not to be applied."

(3) *Agreement needed for effects of extraordinary inflation to be taken into account.* — "Lest, it be overlooked, Article 1250 of the Code, as couched, clearly provides that the value of the peso at the time of the establishment of the obligation shall control and be the basis of payment of the contractual obligation, unless there is 'agreement to the contrary.' It is only when there is a contrary agreement that extraordinary inflation will make the value of the currency at the time of payment, not at the time

of the establishment of obligation, the basis for payment. The Court, in Mobil Oil Philippines, Inc. vs. Court of Appeals and Fernando A. Pedrosa (180 SCRA 651, 667 [1989]), formulated the same rule in the following wise:

> 'In other words, an agreement is needed for the effects of an extraordinary inflation to be taken into account to alter the value of the currency at the time of the establishment of the obligation which, as a rule, is always the determinative element, to be varied by agreement that would find reason only in the supervention of extraordinary inflation or deflation.'

To be sure, neither the trial court, the CA nor respondent has pointed to any provision of the covering B/Ls whence respondent sourced its contractual right under the premises where the defining 'agreement to the contrary' is set forth. Needless to stress, the Court sees no need to speculate as to the existence of such agreement, the burden of proof on this regard being on respondent. x x x The order for recomputation as of the date of payment in accordance with the provisions of Article 1250 of the Civil Code is deleted." *(Telengtan Brothers & Sons, Inc. vs. United States Line, Inc., 483 SCRA 458 [2006].)*

**Devaluation and depreciation distinguished.**

It may be helpful to distinguish between the two terms.

*Devaluation* involves an official reduction in the value of one currency from an officially fixed level imposed by monetary authorities. *Depreciation,* on the other hand, refers to the downward change in the value of one currency in terms of the currencies of other nations which occurs as a result of market forces in the foreign exchange market.

The Philippines presently maintains a floating foreign exchange rate system and not an officially fixed rate regime. So, any lowering of the value of the peso as a result of foreign exchange market forces is a depreciation and not a devaluation.

Both refer to the decrease in the value of the currency. If devaluation is used in that sense by the parties to the contract, it may be regarded as synonymous with depreciation.

ILLUSTRATIVE CASE:

*Lessor demanded a proportionate increase of rental in view of the decrease in the par value of the peso effected by executive order of the President.*

*Facts:* The lease contract between R (lessor) and E (lessee) provides that "in the event of an official devaluation or appreciation of the

Philippine currency, the rental specified herein shall be adjusted in accordance with the provisions of any law or decree declaring such devaluation or appreciation as may specifically apply to rentals."

On November 6, 1965, the President promulgated Executive Order No. 195 which changed the par value of peso from U.S. $0.50 to U.S. $0.2564103 (U.S. Dollar of the weight and fineness in effect on July 1, 1944). By reason of the executive order, R demanded a proportionate increase of the monthly rental. E refused.

*Issue:* Did Executive Order No. 195, in effect, decrease the worth or value of our currency such that a "devaluation" or "depreciation" has taken place which would justify the proportionate increase of rent?

*Held*: Yes. The resultant decrease in the par value of the currency is precisely the situation or event contemplated by the parties in their contract. Devaluation is an official act of the government (as when a law is enacted thereon) and refers to a reduction of the metallic content. Depreciation can take place with or without an official act, and does not depend on metallic content (although depreciation may be caused by devaluation).

In the case at bar, while no express reference has been made to metallic content, there nonetheless is a reduction in par value or in the purchasing power of Philippine currency. Even assuming that there has been no official devaluation as the term is technically understood, the fact is that there has been a diminution or lessening in the purchasing power of the peso; thus, there has been a "depreciation" (opposite of "appreciation").

Moreover, when laymen unskilled in the semantics of economics use the terms "devaluation" or "depreciation," they certainly mean them in their ordinary signification — decrease in value. Hence, as contemplated by the parties in their lease agreement, the term "devaluation" may be regarded as synonymous with "depreciation" for certainly both refer to a decrease in the value of the currency. The rental should, therefore, by their agreement, be proportionately increased. *(Del Rosario vs. Shell Company of the Philippines Ltd., 164 SCRA 556 [1988].)*

**ART. 1251. Payment shall be made in the place designated in the obligation.**

**There being no express stipulation and if the undertaking is to deliver a determinate thing, the payment shall be made wherever the thing might be at the moment the obligation was constituted.**

**In any other case the place of payment shall be the domicile of the debtor.**

**If the debtor changes his domicile in bad faith or after he has incurred in delay, the additional expenses shall be borne by him.**

**These provisions are without prejudice to venue under the Rules of Court. (1171a)**

### Place where obligation shall be paid.

Article 1251 gives the rules regarding the place for the payment of an obligation without prejudice to venue under the Rules of Court.

(1) If there is a stipulation, the payment shall be made in the place designated (par. 1; see Art. 1306.);

(2) If there is no stipulation and the thing to be delivered is specific, the payment shall be made at the place where the thing was, at the perfection of the contract (par. 2.);

(3) If there is no stipulation and the thing to be delivered is generic, the place of payment shall be the domicile of the debtor. (par. 3.) In this case, the creditor bears the expenses in going to the debtor's place to accept payment (see Art. 1247.) subject to the rule in paragraph 4.

The order as above enumerated is successive and exclusive as may be gleaned from the provision itself. (De Pamaylo vs. Velasco, [C.A.] No. 21639-R, Jan. 16, 1959.)

*Note: Venue* is the place where a court suit or action must be filed or instituted. (Secs. 1-4, Rule 4, Rules of Court.)

### Concept of domicile.

*Domicile* is the place of a person's habitual residence. (Art. 50.) Residence is only an element of domicile. Residence simply requires bodily presence as an inhabitant in a given place, while domicile (or legal residence) requires bodily presence in that place and also an intention to make it one's domicile. Some cases make a distinction between the two terms but as generally used in statutes fixing venues, they are synonymous and convey the same meaning as the term "inhabitant." (Fule vs. Court of Appeals, 74 SCRA 189 [1976].) The term "residence" is equated with "domicile" or "legal residence" as far as election law is concerned. (Ang Kek Chen vs. Calasan, 528 SCRA 124 [2007].)

It is believed that the term "domicile," as used in Article 1251, connotes "actual" or "physical" habitation of a person as distinguished from "legal" residence.

SUBSECTION 1. — *Application of Payments*

**ART. 1252. He who has various debts of the same kind in favor of one and the same creditor, may declare at the time of making the payment, to which of them the same must be applied. Unless the parties so stipulate, or when the application of payment is made by the party for whose benefit the term has been constituted, application shall not be made as to debts which are not yet due.**

**If the debtor accepts from the creditor a receipt in which an application of the payment is made, the former cannot complain of the same, unless there is a cause for invalidating the contract. (1172a)**

### Meaning of application of payments.

*Application of payments* is the designation of the debt to which should be applied the payment made by a debtor who has various debts of the same kind in favor of one and the same creditor. (Art. 1252, par. 1.)

### Requisites of application of payments.

The requisites are:

(1) There must be one debtor and one creditor;

(2) There must be two or more debts;

(3) The debts must be of the same kind;

(4) The debts to which payment made by the debtor has been applied must be due; and

(5) The payment made must not be sufficient to cover all the debts.

### Application as to debts not yet due.

The application of payments as to debts not yet due cannot be made unless:

(1) there is a stipulation that the debtor may so apply; or

(2) it is made by the debtor or creditor, as the case may be, for whose benefit the period has been constituted. (see Art. 1196; also Art. 1792[10].)

**Rules on application of payments.**

They are as follows:

(1) The debtor has the first choice; he must indicate at the time of making payment, and not afterwards, which particular debt is being paid. (see Powell vs. Phil. National Bank, 54 Phil. 54 [1929].) If, in making use of his right, the debtor applied the payment to a debt, he cannot later claim that it should be applied to another debt.

(2) The right to make the application once exercised is irrevocable unless the creditor consents to the change (see Bachrach Garage and Taxicab Co. vs. Golingco, 39 Phil. 918 [1919]; Kander vs. Dannug, [C.A.] 43 O.G. No. 8, p. 3176.);

(3) It is clear from the use of the word "may" rather than the word "shall" in Article 122 that the debtor's right to apply payment is not mandatory but merely directory. If the debtor does not apply payment, the creditor has the subsidiary right to make the designation by specifying in the receipt which debt is being paid;

(4) If the creditor has not also made the application, or if the application is not valid (par. 2.), the debt, which is most onerous to the debtor among those due, shall be deemed to have been satisfied (Art. 1254, par. 1.);

(5) If the debts due are of the same nature and burden, the payment shall be applied to all of them proportionately. (*Ibid.*, par. 2.); and

(6) If neither party has exercised its option and there is disagreement as to debts to which payment must be applied, the court will apply the payment according to the justice and equity of the case, taking

[10]Art. 1792. If a partner authorized to manage collects a demandable sum, which was owed to him in his own name, from a person who owed the partnership another sum also demandable, the sum thus collected shall be applied to the two credits in proportion to their amounts, even though he may have given a receipt for his own credit only; but should he have given it for the account of the partnership credit, the amount shall be fully applied to the latter.

The provisions of this article are understood to be without prejudice to the right granted to the debtor by Article 1252, but only if the personal credit of the partner should be more onerous to him. (1684)

into consideration all its circumstances. (Premiere Development Bank vs. Central Surety & Insurance Co., Inc., 579 SCRA 359 [2009].)

The rules in Articles 1252 to 1254 apply to a person owing several debts of the same kind to a single creditor. They are not applicable to a person whose obligation as a mere surety is both contingent and singular. *(infra.)*

EXAMPLES:

D owes C as follows:

(a) P1,500.00 payable on September 5;

(b) P1,200.00 payable on September 20;

(c) A specific table worth P2,000.00 to be delivered on September 20; and

(d) P1,000.00 payable on October 15.

(1) On September 20, D paid C P1,500.00. D may apply the P1,500.00 to debt (a), or to debt (b) and (if C does not object) to a portion of debt (a).

If D paid only P1,000.00, he cannot choose to apply his payment to the P1,500.00 debt because C cannot be compelled to receive partial payment. (see Art. 1248.) D cannot properly apply his payment to debt (c) because it is not of the same kind. He must deliver the thing agreed upon. (Art. 1244.) Neither can he apply it to debt (d) which is not yet due unless there is a stipulation to the contrary or he has the benefit of the period.

An application of payment made by the debtor without objection from the creditor is binding upon the latter. His acquiescence is equivalent to an agreement and has the force and efficacy of a contract. (Sanz vs. Lavin, 6 Phil. 299 [1906].)

(2) If D does not make a choice, C can make the designation in the receipt *with the consent of D*. D may change the application made by C. Note that the law says "if the debtor accepts" (par. 2.), which implies that he has the liberty to reject also.

The acceptance by D of the receipt given by C is regarded by the law as contract in itself independent of the principal obligation. His acquiescence to the application made by C amounts to an assent to such application *(Ibid.),* which he may no longer revoke or change (Bachrach Garage & Taxicab Co. vs. Golingco, 39 Phil. 912 [1919].), "unless there is a cause for invalidating the contract" (Art. 1252, par. 2.) as where the consent of D in accepting the receipt was vitiated by reason of fraud, mistake, etc. (see Art. 1330.)

(3) If C does not make the application in the receipt or no receipt was issued by him, then the legal rules in Article 1254 will govern.

ILLUSTRATIVE CASE:

*Creditor (seller) accepted payment from surety of only the amount of the bond and debtor (buyer) contended that there was consequently waiver by creditor of the interest due on said amount.*

*Facts:* D executed in favor of C a promissory note promising to pay the latter P5,000.00, the unpaid balance of the purchase price of a lot sold to D, and the interest thereon. The note is secured by a bond for P5,000.00 executed by S (surety) in favor of C.

When the obligation became due and demandable, S paid C P5,000.00. Subsequently, C tried to recover from D the accrued interest on the P5,000.00.

*Issue:* Did C waive his right to the interest when he accepted only P5,000.00 from S?

*Held:* No. The liability of S under the surety bond is limited to P5,000.00. There was, therefore, no waiver or condonation of the interest due.

D is relying on Article 1253, but the rules contained in Articles 1252 to 1254 apply to a person owing several debts of the same kind to a single creditor. They cannot be made applicable to a person whose obligation as a mere surety is both contingent and singular; his (S's) liability is confined to such obligation, and cannot be extended beyond the terms of the contract, and he is entitled to have all payments made by him applied exclusively to said obligation and to no other. *(Magdalena Estates, Inc. vs. Rodriguez, 18 SCRA 967 [1966].)*

**ART. 1253. If the debt produces interest, payment of the principal shall not be deemed to have been made until the interests have been covered. (1173)**

## Interest earned paid ahead of principal.

The rule laid down in the article is mandatory. Hence, the debtor cannot choose to credit his payment to the principal before the interest is paid. The payment must be applied first to the interest and whatever balance is left, must be credited to the principal. The creditor can refuse an application of the debtor made contrary to the provision of Article 1253. (see Art. 1176; San Jose vs. Ortega, 11 Phil. 442 [1908]; Pimentel vs. Gutierrez, 14 Phil. 49 [1909].)

The rule is subject, however, to any agreement between the parties, or to waiver by the creditor. In this sense, Article 1253 is merely directory.

(1) In a contract involving installment payments with interest chargeable against the remaining balance of the obligation, it is the duty of the creditor to inform the debtor of the amount of interest that falls due and that he is applying the installment payments to cover said interest; otherwise, the creditor cannot apply the payments to the interest and then hold the debtor in default for non-payment of installments on the principal. (Rapanut vs. Court of Appeals, 246 SCRA 323 [1995].)

(2) It has been held that a party to a contract who unqualifiedly and unconditionally accepts the settlement of his claim for damages without reservation as to interest or any other further claim from the other party, is estopped from claiming interest thereafter. (Gozun vs. Republic, 84 Phil. 359 [1949].) But a creditor who accepts payment from a surety of the amount of a bond does not thereby waive his right to recover from the debtor the interest due on said amount. (Magdalena Estates, Inc. vs. Rodriguez, *supra*.)

**ART. 1254. When the payment cannot be applied in accordance with the preceding rules, or if application cannot be inferred from other circumstances, the debt which is most onerous to the debtor, among those due, shall be deemed to have been satisfied.**

**If the debts due are of the same nature and burden, the payment shall be applied to all of them proportionately. (1174a)**

### Application of payment to more onerous debts.

In case no application of payment has been made by the debtor and the creditor, then the payment shall be applied to the most onerous debt, and if the debts are of the same nature and burden, to all of them proportionately.

A debt is more onerous than another when it is more burdensome to the debtor. No fixed rule can be laid down in determining which debt is more onerous to the debtor since the condition of being more burdensome is a question of relative appreciation. The Supreme Court, however, in various decisions has given some rules which can be

followed or used as a guide to determine whether one debt is more burdensome than another.

(1) An interest-bearing debt is more onerous than a non-interest bearing debt even if the latter is an older one. (Menzi & Co. vs. Quing Chuan, 69 Phil. 46 [1939].)

(2) A debt as a sole debtor is more onerous than as a solidary debtor. (Commonwealth vs. Far Eastern Surety, 83 Phil. 305 [1969].) Accordingly, where in a bond the debtor and surety have bound themselves solidarily, but limiting the liability of the surety to a lesser amount than that due from the principal debtor, any such payment as the latter may have made on account of such obligation must be applied first to the unsecured portion of the debt, for, as regards the principal debtor, the obligation is more onerous as to the amount not secured. (Hongkong and Shanghai Banking Corp. vs. Aldanese, 48 Phil. 990 [1926].)

(3) All things being equal, older debts are more onerous. (Phil. National Bank vs. Veraguth, 50 Phil. 233 [1927]; People's Surety & Insurance Co., Inc. vs. Gabriel & Sons Trans. Co., Inc., 9 SCRA 573 [1963]; see Tan vs. Mendez, Jr., 383 SCRA 202 [2002].)

(4) Debts secured by a mortgage or by pledge are more onerous than unsecured debts (Mission de San Vicente vs. Reyes, 19 Phil. 525 [1911]; Sanz vs. Lavin Brothers, 6 Phil. 299 [1906].);

(5) In a case, the unpaid rentals due from the purchaser of property occupied by him were held more onerous than the balance of the price of the property the provisional sale of which was cancelled by the seller for non-payment of the installments; hence, the subsequent payment of P100,000 was applied to the back rentals and not as "additional payment" for the purchase price. (Espina vs. Court of Appeals, 334 SCRA 186 [2000].)

(6) Of two interest-bearing debts, the one with a higher rate is more onerous.

(7) An obligation with a penalty clause is more burdensome than one without penalty clause.

ILLUSTRATIVE CASE:

*The court did not apply the down payment to creditor (seller) of debtor (buyer) to the guaranteed portion of the debt and surety contended that this was contrary to Article 1254.*

*Facts:* To guarantee the faithful compliance by B (buyer) with his obligation under a conditional purchase and sale of six (6) trawl boats, C executed performance bonds in favor of S (seller). In a suit filed by S against B and C for failure of B to pay the amortizations, the lower court rendered a decision in favor of S.

C contended, among other things, that the court had erred in not applying the sum of P10,000.00 paid as down payment on two (2) boats by B to S to the guaranteed indebtedness, reasoning that under Article 1254 of the Civil Code, where there is no imputation (application) of payment made by either the debtor or creditor, the debt which is the most onerous to the debtor shall be deemed to have been satisfied; hence, the amount paid as down payment on its two (2) boats should be applied to the guaranteed portion of the debt.

*Issue:* Is this contention tenable?

*Held:* No. "The rules contained in Articles 1252 to 1254 of the Civil Code apply to a person owing several debts of the same kind to a single creditor. They cannot be made applicable to a person whose obligation as a mere surety is both contingent and singular, which in this case is the full and faithful compliance with the terms of the contract of conditional purchase and sale of reparations goods. x x x." *(Reparations Commission vs. Universal Deep-Sea Surety and Fidelity Co., Inc., 83 SCRA 764 [1978].)*

### Where debts subject to different burdens.

Suppose the debts are subject to different burdens (like one debt secured by a mortgage and the other with a penalty clause) that it cannot be definitely determined which debt is most onerous to the debtor. To what debt should the payment be applied? To all of them proportionately.

SUBSECTION 2. — *Payment by Cession*

**ART. 1255. The debtor may cede or assign his property to his creditors in payment of his debts. This cession, unless there is stipulation to the contrary, shall only release the debtor from responsibility for the net proceeds of the thing assigned. The agreements which, on the effect of the cession, are made between the debtor and his creditors shall be governed by special laws. (1175a)**

### Meaning of payment by cession.

*Payment by cession* is another special form of payment. It is the assignment or abandonment of all the properties of the debtor for

the benefit of his creditors in order that the latter may sell the same and apply the proceeds thereof to the satisfaction of their credits. (8 Manresa 321.)

**Requisites of payment by cession.**

They are:

(1) There must be two or more creditors;

(2) The debtor must be (partially) insolvent;

(3) The assignment must involve all the properties of the debtor; and

(4) The cession must be accepted by the creditors.

**Effect of payment by cession.**

Unless there is a stipulation to the contrary, the assignment does not make the creditors the owners of the property of the debtor and the debtor is released from his obligation only up to the net proceeds of the sale of the property assigned. (Art. 1255.) In other words, the debtor is still liable if there is a balance.

**Article 1255 refers to contractual assignment.**

The assignment of property under Article 1255 refers to voluntary or contractual assignment which requires the consent of all the creditors as distinguished from legal or judicial assignment which is governed by the Insolvency Law. (Sec. 8, Act No. 1956, as amended.) It merely involves a change of the object of the obligation by agreement of the parties and at the same time fulfilling the same voluntarily. (Lopez vs. Court of Appeals, 114 SCRA 671 [1982].)

**Dation in payment and cession distinguished.**

*Dation in payment* or *dacion en pago* is a special form of payment whereby another thing is alienated by the debtor to the creditor who accepts it as equivalent of payment of an existing debt in money. There is no dation if the transfer of property is by way of security only, and not by way of satisfying the debt.

The differences are:

(1) In dation (see Art. 1245.), there is usually only one creditor, while in cession, there are several creditors;

(2) Dation does not presuppose the insolvency of the debtor or a situation of financial difficulties, while in cession, the debtor is insolvent at the time of assignment;

(3) Dation does not involve all the property of the debtor, while cession extends to all the property of the debtor subject to execution;

(4) In dation, the creditor becomes the owner of the thing given by the debtor, while in cession, the creditors only acquire the right to sell the thing and apply the proceeds to their credits *pro rata;* and

(5) Dation is really an act of novation (Art. 1291[1].), while cession is not an act of novation.

Both are substitute forms of payment or performance. They are governed by the law on sales.

SUBSECTION 3. — *Tender of Payment and Consignation*

**ART. 1256. If the creditor to whom tender of payment has been made refuses without just cause to accept it, the debtor shall be released from responsibility by the consignation of the thing or sum due.**

**Consignation alone shall produce the same effect in the following cases:**

**(1) When the creditor is absent or unknown, or does not appear at the place of payment;**

**(2) When he is incapacitated to receive the payment at the time it is due;**

**(3) When, without just cause, he refuses to give a receipt;**

**(4) When two or more persons claim the same right to collect;**

**(5) When the title of the obligation has been lost. (1176a)**

### Meaning of tender of payment and consignation.

(1) *Tender of payment* is the act, on the part of the debtor, of offering to the creditor the thing or amount due. The debtor must show that he has in his possession the thing or money to be delivered at the time of the offer. It is an act preparatory to consignation, which is the principal, and from which are derived the immediate consequences which the debtor desires or seeks to obtain.

(2) *Consignation* is the act of depositing the thing or amount due with the proper court when the creditor does not desire, or refuses to accept payment, or cannot receive it, after complying with the formalities required by law. It is always judicial and it generally requires a prior tender of payment which is by its very nature extra-judicial. (Art. 1256, par. 1.)

**Nature of and rationale for consignation.**

(1) *A facultative remedy.* — Consignation is a facultative remedy which the debtor may or may not avail of.

(a) If made by the debtor, the creditor merely accepts it if he wishes; or the court declares that it has been properly made, in either of which events the obligation is extinguished. Indeed, the law allows the debtor to withdraw the thing or the sum deposited before acceptance by the creditor or cancellation by the court. (see Art. 1260.)

(b) If the debtor has such right of withdrawal, he surely has the right to refuse to make the deposit in the first place. For the court to compel him to do so is a grave abuse of discretion amounting to excess of jurisdiction. If he refuses, the creditor must fall back on the proper coercive processes provided by law to secure or satisfy his credit, as by attachment, judgment, and execution. (Sotto vs. Mijares, 28 SCRA 17 [1969].)

(2) *Avoidance of greater liability.* — Tender of payment and consignation, where validly made, or consignation alone in any of the cases enumerated in Article 1256, produces the effect of payment and extinguishes an obligation. The rationale for this remedy is to avoid the performance of an obligation more onerous to the debtor by reason of causes not imputable to him.

(a) For failure to consign the thing or amount due, the debtor may become liable for damages and/or interest. (Eternal Gardens Memorial Park Corp. vs. Court of Appeals, 282 SCRA 553 [1997]; see Meat Packing Corp. of the Phils. vs. Sandiganbayan, 359 SCRA 409 [2001].)

But such failure is not tantamount to a breach of contract where by the fact of tendering payment he was willing and able to comply with his obligation. (Laforteza vs. Machuca, 333 SCRA 643 [2000].)

(b) In *Gregorio Araneta, Inc. vs. De Palerno* (91 Phil. 786 [1952].), it was ruled. "The matter of the suspension of the running of interest on the loan is governed by principles which regard reality rather than technicality, substance rather than form. Good faith of the offeror or ability to make good the offer should in simple justice excuse the debtor from paying interest after the offer was rejected. A debtor cannot be considered delinquent who offered checks backed by sufficient deposit or ready to pay cash if the creditor chose that means of payment. Technical defects of the offer cannot be adduced to destroy its effects when the objection to accept the payment was based on entirely different grounds. Thus, although the defective consignation made by the debtor did not discharge the mortgage debt, the running of interest on the loan is suspended by the offer and tender of payment." (quoted in Biesterbos vs. Court of Appeals, 411 SCRA 396 [2003].)

**Requisites of a valid consignation.**

In order that the debtor may be released from his obligation by the consignation of the thing or sum due,[11] the following requisites must be observed:

(1) existence of a valid debt which is due (Art. 1256, par. 1.);

(2) tender of payment by the debtor and refusal without justifiable reason by the creditor to accept it *(Ibid.);*

(3) previous notice of consignation to persons interested in the fulfillment of the obligation (Art. 1257, par. 1.);

(4) consignation of the thing or sum due (Art. 1258, par. 1.); and

(5) subsequent notice of consignation made to the interested parties. (*Ibid.,* par. 2; see Gardner vs. Court of Appeals, 27 SCRA 399 [1977].)

The absence of any of the requisites is enough ground to render consignation ineffective. Compliance with the requirements is mandatory. The law speaks of "thing." It makes no distinction between real and personal property.

[11]The law (*e.g.,* Rent Control Law [B.P. Blg. 25].) may sanction another method of payment such as depositing the amount due with a bank, after refusal by the creditor (lessor) to accept the debtor's (lessee's) tender of payment, as an alternative to judicial consignation. (Inductivo vs. Court of Appeals, 229 SCRA 380 [1994].)

**Existence of valid debt.**

Consignation is proper only where there is a valid debt which is due. A creditor-debtor relationship must exist between the parties otherwise the legal effects thereof cannot be availed of.

Thus, where the possession of property by petitioners being by mere tolerance or permission of respondent as they failed to establish through competent evidence the existence of any contractual relations between them, the latter, not being a creditor, has no obligation to receive any payment from them. Without any contract, they are necessarily bound by an implied promise that they will vacate upon demand, failing which, a summary action for ejectment is the proper remedy against them. (Llobrera vs. Fernandez, 488 SCRA 509 [2006].)

**Necessity of making tender of payment and consignation.**

Both tender of payment and consignation must be validly done in order to effect the extinguishment of an obligation. Substantial compliance is not enough for that would render only a directory construction of the law.

(1) The use of the words "shall" and "must" (see Arts. 1257, 1258, 1249.) which are imperative, positively indicate that all the essential requisites must be complied with in order that consignation shall be valid and effectual. (Soco vs. Militante, 123 SCRA 160 [1983]; Manuel vs. Court of Appeals, 199 SCRA 603 [1991]; Licuanan vs. Diaz, 175 SCRA 530 [1989]; see however, Rural Bank of Caloocan vs. Court of Appeals, 104 SCRA 151 [1981], *infra*.)

(2) Consignation and tender of payment must not be encumbered by conditions if they are to produce the intended result of fulfilling the obligation. (Rayos vs. Reyes, 398 SCRA 24 [2003].)

In a case, where the plaintiff sent to defendant a letter with an offer to redeem a foreclosed property together with the redemption price but the defendant's letter of acceptance was not received by the plaintiff until after the redemption period, the court held that the plaintiff was justified in depositing the redemption money in court, although far from rejecting the tender of payment, the defendant in fact accepted it. The court said that the law (Art. 1256, par. 1.), "must be reasonably interpreted and the realities in each case taken into account so that the purpose of the law may not be defeated." (Miranda vs. Reyes, 29 SCRA

160 [1969].) Consignation, however, was not necessary as the plaintiff had no obligation to redeem.

EXAMPLES:

(1) D owes C a sum of money. On the due date of the obligation, D offers to pay the obligation but C refuses to accept the payment without any justifiable reason.

In this case, D's obligation will not be extinguished until he has made a valid consignation.

(2) D entered into a contract with C. D is given the right to cancel the contract upon payment of P1,000.00 to C.

In this case, D has no existing debt to C. The amount of P1,000.00 is not owed by D, being merely the consideration for the exercise of his right to cancel the contract. Hence, consignation of the P1,000.00 is not necessary. Tender of payment in good faith is sufficient to entitle D to cancellation. (see Asturias Sugar Central vs. Pure Cane Molasses Co., 60 Phil. 255 [1934].)

(3) For failing to pay rents for three (3) months, R (lessor) demanded that E (lessee) pay the back rentals and vacate the premises. Subsequently, R filed a complaint for unlawful detainer. E contends that R refused to accept the rents.

The failure of R to collect or his refusal to accept the rentals is not a valid defense. To be released from responsibility, the debtor should consign the thing or sum due. The belated payment of the back rentals by E does not automatically restore the contract of lease without R's consent. (Cursino vs. Bautista, 176 SCRA 65 [1969]; see Cetus Development, Inc. vs. Court of Appeals, 176 SCRA 72 [1989].)

**Requirements for valid tender of payment.**

Tender of payment is the definite act of the debtor of offering the creditor what is due the latter. There must be a fusion of intent, ability and capability to make good such offer, which must be absolute and must cover the amount due. (Far East Bank and Trust Company vs. Diaz Realty, Inc., 363 SCRA 659 [2001].)

(1) Tender of payment must *comply with the rules on payment.* (Arts. 1256-1258.) Thus, a check, whether a manager's check or ordinary check, is not legal tender (see Art. 1249.), and an offer of a check in payment of a debt is not a valid tender and may be refused by the creditor. (Roman Catholic Bishop vs. Intermediate Appellate Court, 191 SCRA 411 [1990]; Abalos vs. Macatangay, Jr., 439 SCRA 649 [2004].)

However, good faith of the offeror or ability to make good the offer should in simple justice excuse the debtor from paying interest after the offer was rejected. A debtor cannot be considered delinquent who offered checks backed by sufficient deposit or ready to pay cash if the creditor chose that means of payment. Technical defects of the offer cannot be adduced to destroy its effects when the objection to accept the payment was based on entirely different grounds. Thus, although the defective consignation made by the debtor did not discharge the loan, the running of the interest on the same is suspended by the offer and tender of payment. (G. Araneta, Inc. vs. Paterno, 91 Phil. 786 [1952]; Francisco vs. Gorgonio, 115 SCRA 395 [1982].)

A tender, even if valid, does not by itself produce legal payment, unless it is completed by consignation. (Phil. National Bank vs. Relativo, 92 Phil. 203 [1952]; Cannu vs. Galang, 459 SCRA 80 [2005].) It has the effect, however, of exempting the debtor from liability for interest.

(2) It must be *unconditional and for the whole amount*. (Joe's Radio Electrical Supply vs. Alto Electronics Corp., 104 Phil. 333 [1958].) It cannot be presumed by a mere inference from surrounding circumstances. (Cebu International Finance Corp. vs. Court of Appeals, 317 SCRA 488 [1999].) The tender of payment of only a portion of an obligation when the contract gives to the creditor the right to require payment of the whole amount due and still unpaid upon default of an installment, may be validly refused by the creditor. (Phil. Charity Sweepstakes Office vs. Olmos, 83 SCRA 188 [1978].)

(3) It must be *actually made*. The manifestation of a desire or intention to pay is not enough. (Catangcatang vs. Legayada, 84 SCRA 5l [1978]; Vda. de Zulueta vs. Octaviano, 121 SCRA 314 [1983]; Belisario vs. Intermediate Appellate Court, 165 SCRA 101 [1988].) Thus, tender of payment cannot be presumed by a mere inference from surrounding circumstances, such as sufficiency of available funds in the hands of the debtor. "A proof that an act could have been done is no proof it was actually done." (Roman Catholic Bishop vs. Intermediate Appellate Court, *supra.*)

ILLUSTRATIVE CASE:

*Tender of payment of an obligation payable in money was made by means of a check.*

*Facts:* D owed C (bank) the sum of P600.00 for which D executed a promissory note. In a suit by C for collection, D claimed that the loan

had already been paid because he had tendered payment at C's Naga Agency, of the loan out of a check for P5,000.00 issued by the United States Treasury in favor of X, who accompanied D, demanding that his check be cashed but the agency dishonored the check which was honored and cashed at a later date by the Legaspi branch of C.

*Issue:* Did the tender of payment by D result in the discharge of his obligation?

*Held:* No, for the following reasons: First, the promissory note executed by D undertook to pay in Philippine currency, and as the tender of payment was made in check, and not his own at that, C acted rightly in refusing it. This is true even if the check may be good. Second, the tender of payment was conditional. In offering the check, D practically told C: "Here is P600.00 but you must pay the remainder of the check (P4,400.00) to X." Third, tender of payment, even if valid, does not by itself produce legal payment, unless it is completed by consignation. (*Phil. National Bank vs. Relativo, 92 Phil. 203 [1952];* see Cuaycong vs. Ruiz, 86 Phil. 170 [1950]; see also Llamas vs. Abaya, 60 Phil. 502 [1934].)

### Proof of tender of payment.

As tender of payment must precede consignation, the tender must be proved by the debtor in the proper case. (Art. 1256, par. 1.) In other cases, when tender is not required (*Ibid.*, par. 2.), only prior notice to interested persons of the consignation need be proved.

In a case, the court ruled that a letter by the tenant to the landlord to get the rental for a particular month is no proof of tender of payment of other or subsequent rentals; a letter to withdraw from the court the rental for a particular month or months referred to therein is no proof of any other deposit or consignation nor even proof of tender of payment of said rental that should have preceded the consignation or of notice to consign; and the lessee must make a tender of payment and give prior notice of consignation and second notice of each consignation of every monthly rental. (Soco vs. Militante, 123 SCRA 160 [1983].)

### When tender of payment not required.

In the five (5) cases mentioned in the second paragraph of Article 1256, tender of payment is not necessary before the debtor can consign the thing due with the court.

(1) It has been held that a creditor who, without legal justification, informs his debtor that payment of a debt will not be accepted, thereby waives payment on the date when the payment will be due; and as a

consequence, the debtor is, in such case, excused from making a formal tender of the money on such date. A debtor does not incur default by failing to make a fruitless tender after notification from the creditor that the money will not be received. (Kapisanan Banahaw vs. Dejarme and Alvero, 55 Phil. 339 [1930].)

(2) In another case, it appears that at the time of consignation the mortgagee (bank) had long foreclosed the mortgage extrajudicially and the sale of the mortgaged property had already been scheduled for non-payment of the obligation, and that despite the fact that mortgagee already knew of the deposit made by the mortgagor because the receipt of the deposit was already attached to the record of the case, said mortgagee had not made any claim of such deposit.

Under the circumstances, the court held that there was substantial compliance with the provision of Article 1256. The mortgagor was right in thinking that it was futile and useless for her to make previous offer and tender of payment directly to the mortgagee, and, therefore, the consignation made by her was valid, if not under the strict provision of the law, under the more liberal considerations of equity. (Rural Bank of Caloocan vs. Court of Appeals, 104 SCRA 151 [1981].)

**ART. 1257. In order that the consignation of the thing due may release the obligor, it must first be announced to the persons interested in the fulfillment of the obligation.**

**The consignation shall be ineffectual if it is not made strictly in consonance with the provisions which regulate payment. (1177)**

### Prior notice to persons interested required.

In the absence of prior notice to the persons interested in the fulfillment of the obligation (such as guarantors, mortgagees, solidary debtors, solidary creditors), the consignation, as payment, shall be void. (Soco vs. Militante, *supra;* Valdellon vs. Tengco, 141 SCRA 321 [1986].)

The purpose of the notice is to give the creditor a chance to reflect on his previous refusal to accept payment considering that the expenses of consignation shall be charged against him (Art. 1259.) and that in case of loss of the thing consigned, he shall bear the risk thereof. (Art. 1262.) Such being the object of the previous notice, it stands to reason that the same should not contain a mere warning that the deposit of

the thing tendered would be made in court but should fix the date and hour of the consignation and the name of the court where the same would be made. (Ochoa vs. Lopez, [C.A.] No. 7050-R [1954].)

Tender of payment and notice of consignation may be done in the same act, *e.g.*, sending a letter that should the creditor fail to accept the payment tendered, the debtor would consign the amount in court. (Ramos vs. Sarao, 451 SCRA 103 [2005].)

**Consignation must comply with provisions on payment.**

Consignation, to amount to a valid payment, must also comply with the provisions which regulate payment. (par. 2; see Arts. 1233, 1239, 1244, 1246, 1248, 1249, 1253.)

(1) One of the rules is that payment should be made in legal tender. (see Art. 1249.) The general rule is that an offer of a bank check for the amount due is not a good tender and this is true even though the check is certified or is a manager's check, except where no objection is made on that ground (62 C.J. 668; De Legarda vs. Miailhe, 88 Phil. 637 [1951]; see Vda. de Eduque vs. Ocampo, 86 Phil. 216 [1950].), and the fact that in previous years payment in check was accepted does not place a creditor in estoppel in requiring the debtor to pay his obligation in cash. (Soco vs. Militante, *supra*.)

(2) While the approval of the court or the obligee's acceptance of the deposit is not necessary where the obligor has performed all acts necessary to a valid consignation such that court approval thereof cannot be doubted, this is true only where there is unmistakable evidence on record that the prerequisites of a valid consignation are present, especially the conformity of the proferred payment to the terms of the obligation which is to be paid. (Rayos vs. Reyes, 398 SCRA 24 [2003]; China Insurance and Surety Co. vs. B.K. Berkenkotter, 83 Phil. 459 [1949].)

**Tender of payment of judgment.**

Tender of payment of the amount due on a judgment into court is not the same as tender of payment of a contractual debt and consignation of the money due from a debtor to a creditor. Hence, the requirements of Articles 1256 and 1257 are not applicable.

In case of a refusal of tender of payment of a judgment, the court may direct the money to be paid into court, and after this payment is

done, order satisfaction of the judgment to be entered. (Del Rosario vs. Sandico, 85 Phil. 170 [1949]; Arzaga vs. Rumboa, 91 Phil. 499 [1952].)

**ART. 1258. Consignation shall be made by depositing the things due at the disposal of judicial authority, before whom the tender of payment shall be proved, in a proper case, and the announcement of the consignation in other cases.**

**The consignation having been made, the interested parties shall also be notified thereof. (1178)**

### Consignation must be with proper judicial authority.

Consignation, by depositing the thing or sum due with the proper judicial authority (*i.e.,* court), is necessary to effect payment. It cannot be elsewhere (*e.g.,* bank) unless otherwise prescribed by special law (*e.g.,* Pres. Decree No. 25, *re* rental). (see Landicho vs. Tensuan, 151 SCRA 410 [1987]; Uy vs. Court of Appeals, 178 SCRA 671 [1989]; Ercillo vs. Court of Appeals, 192 SCRA 163 [1990].)

(1) A written tender of payment alone, without consignation in court of the sum due, does not suspend the accruing of regular or monetary interest. Tender of payment must be accompanied or followed by consignation in order that the effects of payment may be produced. (State Investment House, Inc. vs. Court of Appeals, 198 SCRA 390 [1991]; Masantol Rural Bank, Inc. vs. Court of Appeals, 204 SCRA 752 [1991].)

(2) Where an obligor, however, fails to make a consignation after a valid tender of payment, the court may allow him time to pay the obligation without rescinding the contract. (McLaughlin vs. Court of Appeals, 144 SCRA 673 [1986].) The purchaser cannot be blamed for her failure to consign the amount due where inspite of her willingness and persistence to make payment of the residual amount of the purchase price, the seller injustifiably refused to accept the tender of payment and even opposed her motion to deposit with the trial court which denied said motion. (Vilario vs. Court of Appeals, 304 SCRA 155 [1999].)

(3) Where the judgment of the Court of Appeals in an ejectment case had already become final and executory and the records had in fact been remanded to the lower court, the Court of Appeals is no longer the proper entity to which consignation of rents should be

made particularly where the lessee had been previously requested to make the deposit directly with the lessor. (Valdellon vs. Tengco, 141 SCRA 32 [1986].)

There seems to be no reason why the rules on consignation should not also apply to immovable property.

(4) The consignation has a *retroactive effect*. The payment is deemed to have been made at the time of the deposit of the thing in court or when it was placed at the disposal of the judicial authority. The rationale for consignation is to avoid making the performance of an obligation more enerous to the debtor by reason of causes not imputable him. (Ramos vs. Sarao, 451 SCRA 103 [2005].)

**Notice to be given to interested parties of consignation made.**

After the consignation has been made, the interested parties must also be notified thereof. In a case, this requirement was held fulfilled by the service of summons upon the defendants together with a copy of the complaint. (Limkako vs. Limkako, 74 Phil. 313 [1944].)

The purpose of the second notice is to enable the creditor to withdraw the thing or sum deposited or take possession in case he accepts the consignation. "Indeed, it would be unjust to make him suffer the risk for any deterioration, depreciation or loss of such goods or money by reason of lack of knowledge of such consignation." (Cabanos vs. Calo, 104 Phil. 1058 [1958]; Licuanan vs. Dias, 175 SCRA 530 [1989].)

**Consignation applicable only to payment of debt.**

Judicial consignation is an incident to an action to compel acceptance by the creditor of payment of a debt. It is not applicable where there is no obligation to pay.

(1) Consignation is not necessary in case where a privilege or right (not an obligation) exists, as in the case of a mortgage-debtor (or his successor-in-interest) who desires *to redeem* the mortgaged property (Villegas vs. Capistrano, 9 Phil. 416 [1907]; Asturias Sugar Central, Inc. vs. The Pure Cane Molasses Co., Inc., 60 Phil. 255 [1934].), or a co-heir (Art. 1088.), or a co-owner (Art. 1620.), or a vendor *a retro* (Art. 1602.) who wants *to repurchase* the property sold (Immaculata vs.

Navarro, 160 SCRA 211 [1988]; Rosales vs. Reyes and Ordovez, 25 Phil. 495 [1913]; Mariano vs. Court of Appeals, 222 SCRA 736 [1993].) or a lessee with option to buy who desires *to exercise the right of option* as he has no obligation to pay the price until the execution of the deed of sale in his favor (Quirino vs. Palarca, 29 SCRA 1 [1969]; Francisco vs. Bautista, 192 SCRA 388 [1990]; Nietes vs. Court of Appeals, 46 SCRA 654 [1972]; Heirs of Luis Bacus vs. Court of Appeals, 359 SCRA 126 [2001].); hence, tender of payment would be sufficient to preserve the right or privilege. (Torcuator vs. Bernabe, 459 SCRA 439 [2005].)

A contract involves the performance of an obligation, not merely the exercise of a right or privilege. (Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995].)

(2) The formal *offer to redeem* by a co-owner or adjoining owner (under Arts 1620-1623.) accompanied by a *bona fide* tender of payment within the period for redemption prescribed by the contract or by law is sufficient to preserve the right of redemption for future enforcement beyond such period and within the period prescribed for the action by the statute of limitations. Where the right to redeem is excused thru the filing of a judicial action within the period prescribed for redemption, such filing is equivalent to a formal offer to redeem. (Hulganza vs. Court of Appeals, 147 SCRA 779 [1987]; see Villegas vs. Court of Appeals, 499 SCRA 276 [2006].)

The deposit of the redemption money with the sheriff is sufficient to effect payment of the redemption price; and when tender has been refused, it is not necessary that such tender be followed by consignation. (De Castro vs. Intermediate Appellate Court, 165 SCRA 654 [1988].) But mere tender of payment is not in itself a payment that relieves the vendor or mortgagor from his liability to pay the redemption price. (see Paez vs. Magno, 83 Phil. 403 [1949]; Catangcatang vs. Legayada, 84 SCRA 51 [1978].)

(3) But where the effect of a judgment whereby the vendor *a retro* is allowed to repurchase the property within a certain period is to definitely settle by judicial declaration the respective rights of the parties and fix the relation of the vendor *a retro* and the vendee *a retro* as that of debtor and creditor, respectively, in the amount and within the period fixed in the judgment, and not that of a vendor and a vendee under the terms of a private agreement equivocal in nature, the vendor (debtor) must consign the full amount of the repurchase price,

if the vendee (creditor) refuses to allow the redemption. (Torrijos vs. Crisologo, 6 SCRA 184 [1962].)

**Property deposited with court exempt from attachment.**

It is a well-established doctrine in practically every jurisdiction that money deposited with a clerk of court is exempt from attachment and not subject to execution. (Springer vs. Odlin, 3 Phil. 344 [1904]; 23 C.J. 357.) It is said to be in *custodia legis* and cannot be withdrawn without an express order of the court.

The fact that no subsequent notice of consignation is made is of no moment. It does not mean, however, that the debtor shall be released from his liability. (see Manjero vs. Buyson Lampa, 61 Phil. 66 [1934].)

**ART. 1259. The expenses of consignation, when properly made, shall be charged against the creditor. (1179)**

**Liability of creditor for expenses of consignation.**

The consignation is made necessary because of the fault or unjust refusal of the creditor to accept payment. That being the case, it is but just that the expenses should be charged against him. Of course, the expenses are chargeable to the debtor if the consignation is not properly made.

**When consignation deemed properly made.**

In any of the following cases:

(1) When the creditor accepts the thing or sum deposited, without objection, as payment of the obligation (Art. 1260, par. 2.);

(2) When the creditor questions the validity of the consignation, and the court, after hearing, declares that it has been properly made *(Ibid.);* and

(3) When the creditor neither accepts nor questions the validity of the consignation, and the court after hearing, orders the cancellation of the obligation. (Art. 1260, par. 1; Salaria vs. Buenviaje, 81 SCRA 722 [1978]; Ponce de Leon vs. S. Syjuico, Inc., 90 Phil. 311 [1951].)

The creditor may accept the consignation with reservation or qualification; therefore, he is not barred from raising the claims he reserved against the debtor. (Riesenbeck vs. Court of Appeals, 209 SCRA 656 [1992].)

**ART. 1260. Once the consignation has been duly made, the debtor may ask the judge to order the cancellation of the obligation.**

**Before the creditor has accepted the consignation, or before a judicial declaration that the consignation has been properly made, the debtor may withdraw the thing or the sum deposited, allowing the obligation to remain in force. (1180)**

### Withdrawal by debtor of thing or sum deposited.

The observance of all the requisites of consignation operates as a valid payment; hence, the debtor can move for the cancellation of the obligation by the court. The debtor, however, may withdraw as a matter of right the thing or sum deposited (1) before the creditor has accepted the consignation or (2) before a judicial declaration that the consignation has been properly made, as he is still the owner of the same. In such a case, the obligation shall continue to remain in force. All expenses are paid by the debtor. If the withdrawal is with the consent of the creditor, Article 1261 applies.

While it is incumbent upon the court to allow withdrawal before acceptance by the creditor or judicial approval of the consignation, the depositor cannot recover the thing or sum without an express order of restitution. (TLG International Continental Enterprising, Inc. vs. Flores, 47 SCRA 437 [1972].) Strictly speaking, a formal complaint must be commenced with the proper court to provide the venue for the determination of whether there was valid tender of payment or consignation. (Mongao Price Properties Corporation, 467 SCRA 201 [2005].)

### Risk of loss of thing or sum consigned.

Where all the requisites for a valid consignation have been complied with, the loss of the thing or amount consigned occurring without the fault of the debtor before the acceptance of the consignation by the creditor or its approval by the court is for the account of the creditor.

The risk of loss before acceptance by the creditor or approval by the court is mutual, because if it be determined that there was no valid consignation, the loss must be suffered by the debtor. (Sia vs. Court of Appeals and Valencia, 92 Phil. 355 [1952].)

**ART. 1261. If, the consignation having been made, the creditor should authorize the debtor to withdraw the same, he shall lose every preference which he may have over the thing. The co-debtors, guarantors and sureties shall be released. (1181a)**

### Effect of withdrawal with authority of creditor.

Since consignation is for the benefit of the creditor, he may authorize the debtor to withdraw the deposit after he has accepted the same or after the court has issued an order cancelling the obligation. As far as the debtor and the creditor are concerned, their relations will remain as they were before acceptance or cancellation. However, the creditor shall lose every preference which he may have over the thing, and the co-debtors (referring to solidary debtors), guarantors, and sureties shall be released.

The solidary debtors are released only from their solidary liability, but not from their shares of the obligation, since unlike guarantors and sureties, they are also principal debtors.

EXAMPLES:

(1) D is indebted to C in the sum of P10,000.00 with G as the guarantor. On the due date of the obligation, D offered payment but C refused to accept the same. So, D made a consignation. Subsequently, D withdrew the deposit after securing the consent of C.

Under Article 1261, C shall lose whatever preference he may have over the amount and G, the guarantor, shall be released.

(2) If, in the example given, D and G are solidarily liable to C, G is released only from his solidary liability but he is still liable to C for P5,000.00, his share in the obligation.

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## SECTION 2. — *Loss of the Thing Due*

**ART. 1262. An obligation which consists in the delivery of a determinate thing shall be extinguished if it should be lost or destroyed without the fault of the debtor, and before he has incurred in delay.**

**When by law or stipulation, the obligor is liable even for fortuitous events, the loss of the thing does not extinguish the obligation, and he shall be responsible for damages. The same rule applies when the nature of the obligation requires the assumption of risk. (1182a)**

### When a thing considered lost.

It is understood that the *thing is lost* when it perishes, or goes out of commerce or disappears in such a way that its existence is unknown or it cannot be recovered.[1] (Art. 1189, par. 2.)

Loss of a determinate thing under Article 1262 (par. 1.) is the equivalent of impossibility of performance in obligations to do referred to in Article 1266. But "loss of the thing due," as used in Article 1231(1) and the above section, extends to both obligations to give and obligations to do.

### When loss of thing will extinguish an obligation to give.

In order that an obligation to give may be extinguished by the loss of the thing, the following requisites must be present:

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[1] "In a very real sense, the interplay of the ensuing factors: a) the BDO-EPCIB merger; and b) the cancellation of subject [E-PCIB] shares [of SSS] and their replacement by totally new common shares of BDO, has rendered the erstwhile 187.84 million E-PCIB shares of SSS 'unrecoverable' in the contemplation of [Article 1189, par. 2].) x x x In net effect, therefore, the 187.84 million E-PCIB common shares are now lost or inexistent." (Osmeña III vs. Social Security System, 533 SCRA 313 [2007].)

(1) The obligation is to deliver a specific or determinate thing;

(2) The loss of the thing occurs without the fault of the debtor; and

(3) The debtor is not guilty of delay.

### When loss of thing will not extinguish liability.

There are cases, however, when the loss of the specific thing even in the absence of fault and delay will not exempt the debtor from liability. They are:

(1) when the law so provides (Arts. 1170, 1165[par. 3], 1263.);

(2) when the stipulation so provides;

(3) when the nature of the obligation requires the assumption of risk (par. 2; see Art. 1174.); and

(4) when the obligation to deliver a specific thing arises from a crime. (see Art. 1268.)

**ART. 1263. In an obligation to deliver a generic thing, the loss or destruction of anything of the same kind does not extinguish the obligation. (n)**

### Effect of loss of a generic thing.

The above article is an example of a case where the debtor is liable even for a fortuitous event because the law says so. It is based on the principle that a generic thing never perishes *(genus nunquam perit).* (see Yu Tek & Co. vs. Gonzales, 29 Phil. 384 [1915]; Bunge vs. Camenforte & Co., 91 Phil. 861 [1952]; De Leon vs. Soriano, 87 Phil. 193 [1950]; Lacson vs. Diaz, 87 Phil. 150 [1950]; Phil. Long Distance Tel. Co. vs. Jeturian, 97 Phil. 981 [1955].)

The debtor can still be compelled to deliver a thing of the same kind. The creditor, however, cannot demand a thing of superior quality and neither can the debtor deliver a thing of inferior quality. (see Art. 1246.)

EXAMPLES:

(1) S promised to deliver 100 cavans of rice to B. The 100 cavans of rice which S intended to deliver were lost in a flood.

S is still liable to B because his obligation is to deliver a generic thing, and it can still be paid from other sources.

(2) Suppose the obligation of S is to deliver 100 cavans of rice from the harvest made by him and such harvest is completely lost or destroyed, is the obligation extinguished?

Yes, because the rice stipulated to be delivered is confined to a particular class and may thus be considered a determinate thing.

ILLUSTRATIVE CASE:

*Loss of the security given for an obligation to deliver a generic thing.*

*Facts:* D obtained loans from C secured by a chattel mortgage on the standing crops of the land owned by him. These crops were lost or destroyed through enemy action during the war.

*Issue:* Is D's obligation to pay the loans extinguished?

*Held:* No. The obligation of D is not to deliver a determinate thing, namely, the crops to be harvested from his land but to pay a generic thing, the amount of money representing the total sum of his loans, with interest.

The chattel mortgage stood as a security for the fulfillment of his obligation, and the loss of the crops did not extinguish his obligation to pay, because the account could still be paid from other sources aside from the mortgaged crops. (*Republic vs. Grijaldo, 15 SCRA 681 [1965]*; see Lawyer's Cooperative Publishing Co. vs. Tabora, 13 SCRA 762 [1965]; see De Leon vs. Rehabilitation Finance Corp., 36 SCRA 289 [1970].)

**ART. 1264. The courts shall determine whether, under the circumstances, the partial loss of the object of the obligation is so important as to extinguish the obligation. (n)**

## Effect of partial loss of a specific thing.

There is partial loss when only a portion of the thing is lost or destroyed or when it suffers depreciation or deterioration. Partial loss is the equivalent of difficulty of performance in obligations to do. (Art. 1267.)

In case of partial loss, the court is given the discretion, in case of disagreement between the parties, to determine whether under the circumstances it is so important in relation to the whole as to extinguish the obligation. In other words, the court will decide whether the partial loss is such as to be equivalent to a complete or total loss.

EXAMPLE:

S obliged himself to deliver to B a specific race horse. The horse met an accident as a result of which it suffered a broken leg. The injury is permanent. Here, the partial loss is so important as to extinguish the obligation.

If the loss is due to the fault of S, he shall be obliged to pay the value of the horse with indemnity for damages.

If the horse to be delivered is to be slaughtered by B, the injury is clearly not important. Even if there was fault on the part of S, he can still deliver the horse with liability for damages, if any, suffered by B.

**ART. 1265. Whenever the thing is lost in the possession of the debtor, it shall be presumed that the loss was due to his fault, unless there is proof to the contrary, and without prejudice to the provisions of Article 1165. This presumption does not apply in case of earthquake, flood, storm or other natural calamity. (1183a)**

### Presumption of fault in case of loss of thing in possession of the debtor.

The article establishes a disputable presumption of fault whenever the thing to be delivered is lost in the possession of the debtor. This presumption is reasonable because the debtor who has the custody and care of the thing can easily explain the circumstances of the loss. The creditor has no duty to show that the debtor was at fault. It is the debtor who must prove that he was not at fault. (see Palacio vs. Sudario, 7 Phil. 275 [1907]; Atlantic Mutual Ins. Co. vs. Macondray & Co., Inc., 2 SCRA 603 [1961]; Malayan Ins. Co., Inc. vs. Manila Port Service, 28 SCRA 65 [1969].)

Under the third paragraph of Article 1165, the obligor who is not at fault is still liable in case he is guilty of delay or has promised to deliver the same thing to two or more persons who do not have the same interest.

### When presumption not applicable.

"In case of natural calamities, the presumption of fault does not apply. Lack of fault on the part of the debtor is more likely. So it is unjust to presume negligence on his part." (Report of the Code Commission, p. 133.)

EXAMPLES:

(1) B borrowed the car of L. On the due date of the obligation, B told L that the car was stolen and that he was not at fault. That is not enough to extinguish B's obligation. It is presumed that the loss was due to his fault. Hence, he is liable unless he proves the contrary.

(2) Suppose the house of B was destroyed because of fire. It is *admitted* that there was a fire and it was accidental and that the car was in the house at the time it occurred. Here, B is not liable unless L proves fault on the part of B. (Arts. 1174, 1262.)

**ART. 1266. The debtor in obligations to do shall also be released when the prestation becomes legally or physically impossible without the fault of the obligor. (1184a)**

## Effect of impossibility of performance.

This article lays down an exception to the obligatory force of contract. (see Art. 1159.) It refers to a case when, without the obligor's fault, an obligation to do becomes legally or physically impossible. The supervening impossibility of performance will result in the extinction of the debtor's obligation after restitution of what he may have received, if any, in advance from the other contracting party. The debtor incurs no liability for his inability to perform.

For example, in a case, the employer was held not liable for breach of an employment contract, where the second contract expressly made the renewal of the employee's residence and work permit by the concerned authorities in Saudi Arabia, a condition to his continued employment in said country. The condition was resolutory in nature, that is, the non-renewal had the effect of resolving or rendering cancellable the employment contract and releasing the employer from its obligation to continue the employment. (Phil. National Construction Corp. vs. National Labor Relations Commission, 193 SCRA 401 [1991].)

This impossibility must take place after the constitution of the obligation. If the obligation is impossible from the very beginning, the obligation is void. (see Arts. 1183, 1348.) In such case, there is no obligation to be extinguished. Note that Article 1266 makes express reference to obligations to do or personal obligations. In obligations not to do, impossibility of performance can hardly take place.

**Kinds of impossibility.**

(1) In purely personal obligations, when the personal qualifications of the obligor are involved, physical impossibility takes place when, for example, the obligor dies or becomes physically incapacitated to perform the obligation. The law does not make any distinction as to whether or not the obligation can still be performed by others. However, if the impossibility is due to the fault or negligence of the obligor, he shall be liable for damages.

(2) *Legal impossibility* occurs when the obligation cannot be performed because it is rendered impossible by provision of law, although physically it may be possible of performance.

ILLUSTRATIVE CASES:

1. *Impossibility of performance refers not to the obligation itself but to the intended use of the money to be paid.*

*Facts:* S sold to B an undivided 1/2 interest in a vessel for the sum of P36,000.00. The sum of P10,000.00 was paid, and it was agreed that the balance of P26,000.00 was to be applied by B to the cost of installing a new engine in the vessel.

The vessel was wrecked by a storm, a fortuitous event.

*Issue:* Is B released from the obligation to pay the balance inasmuch as the installation of the engine has become impossible?

*Held:* No. The obligation of B was not limited to the duty to install a motor on the vessel. The true intention of the parties under their contract was that the unpaid balance should be applied to the installation of a motor after it had been paid by B. In other words, there was an obligation on his part to pay the balance independently of the purpose for which it was intended to be used; and this obligation to pay continued to subsist notwithstanding the fact that it has become impossible to use the money in the particular way that was intended. *(Millan vs. Rio Olabarrieta, 45 Phil. 718 [1924].)*

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2. *Lack of funds is alleged for failure to fulfill an obligation.*

*Facts:* S sold a parcel of land to B for P10,000.00. B paid S P2,000.00 on the signing of the contract but failed to pay the first installment on the balance. B alleged lack funds for his failure and, therefore, pleaded impossibility of performance.

*Issue:* Is the contention of B tenable?

*Held:* No. The stability of commercial transactions requires that the rights of the seller be protected just as effectively as the rights of the buyer. The rule of equity jurisprudence applicable in this case is that mere pecuniary inability to fulfill an engagement does not discharge the obligation of the contract, nor does it constitute a defense to a decree of specific performance. *(Gutierrez Repide vs. Alzelius, 39 Phil. 190 [1918].)*

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3. *Performance of the obligation is possible but dangerous to life and property.*

*Facts:* S (a sugar central) obligated itself to construct a railroad to extend to the hacienda of B "whenever the contour of the land, the curves, and elevations permit the same." It was later shown that while it was possible to construct the railroad to B's hacienda, to do so would be very dangerous.

B instituted action against S for breach of contract to construct the railroad in question and to recover damages arising from his inability to mill the cane planted on his hacienda.

*Issue:* May one obligate himself to do something, which when accomplished, will prove to be too dangerous to life and property?

*Held:* No. The contract in question was a general contract of the form used by the central and various proprietors of sugar cane fields. It was intended to be limited in particular application to haciendas not impeded by physical impossibility. The contract was qualified by an implied condition which, if given practical effect, results in absolving S from its promise. Not to sanction an exception to the general rule would run counter to public policy and the law by forcing the performance of a contract undesirable and harmful. *(Labayen vs. Talisay-Silay Milling Co., 52 Phil. 440 [1928].)*

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4. *Performance would violate a government order and be contrary to public policy.*

*Facts:* E (lessee) failed, during the Japanese occupation, to comply with the terms of his contract for the lease of a hacienda dedicated to the planting of sugar cane. The failure was due to an order of the President of the Philippines suspending the milling of sugar cane or prohibiting such planting during the enemy occupation, or to the fact that E was prevented from doing so by the uncertain conditions of peace and order then prevailing, which the courts may well take judicial notice thereof.

*Issue:* Should E be relieved from responsibility for such failure?

*Held:* Yes. In the light of the authorities and precedents, such causes are deemed sufficient to justify non-fulfillment.

This is more so if we take into account the fact that to produce or mill sugar cane at that time was contrary to public policy as it would be giving aid and comfort to the enemy, and was in violation of a specific order emanating from our legitimate government to forestall any help that may be rendered the enemy in his war effort it being an undisputed fact that sugar is essential not only to feed the enemy but as raw material for fuel to bolster up his war machine. *(Castui vs. Longa, 89 Phil. 581 [1951].)*

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5. *Consignee refused to take delivery of overshipment of goods on the ground that it would cause it to violate customs, tariff and Central Bank rules and regulations.*

*Facts:* SLS, private respondent, a foreign shipping company, received at its Hongkong terminal a sealed container containing 76 bales of "unsorted waste paper" for shipment to KHPP, petitioner, in Manila. A bill of lading to cover the shipment was issued to SLS.

Despite notices of arrival, KHPP failed to discharge the shipment from the container. Demurrage charges accrued after numerous demands. SLS commenced the civil action for collection and damages. (*Note:* Demurrage is an allowance or compensation for the delay or detention of a vessel.)

In its answer, KHPP alleged that it purchased 50 tons of waste paper from the shipper in Hongkong; that the shipment SLS was asking KHPP to accept was 20 metric tons which is 10 metric tons more than the remaining balance; that if KHPP were to accept the shipment, it would be violating Central Bank rules and regulations and customs and tariff laws, and that the cause of action would be against the shipper which contracted SLS's service.

*Issue:* Did KHPP violate the terms of the bill of lading by its prolonged failure to receive and discharge the cargo from SLS's vessel and thus become liable for demurrage to the latter?

*Held:* Yes. (1) *Petitioner liable for demurrage.* — "Petitioner's attempt to evade its obligation to receive the shipment on the pretext that this may cause it to violate customs, tariff and Central Bank laws must likewise fail. Mere apprehension of violating said laws, without a clear demonstration that taking delivery of the shipment has become legally impossible, cannot defeat the petitioner's contractual obligation and liability under the bill of lading.

In the case at bar, the prolonged failure of petitioner to receive and discharge the cargo from the private respondent's vessel constitutes a

violation of the terms of the bill of lading. It should thus be liable for demurrage to the former."

(2) *Petitioner's remedy against seller/shipper.* — "The discrepancy between the amount of goods indicated in the invoice and the amount in the bill of lading cannot negate petitioner's obligation to private respondent arising from the contract of transportation. Furthermore, private respondent, as carrier, had no knowledge of the contents of the container. The contract of carriage was under the arrangement known as 'Shipper's Load And Count,' and the shipper was solely responsible for the loading of the container while the carrier was oblivious to the contents of the shipment. Petitioner's remedy in case of overshipment lies against the seller/shipper, not against the carrier." *(Keng Hua Paper Product, Co., Inc. vs. Court of Appeals, 286 SCRA 257 [1998].)*

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6. *Performance of obligation by principal is prevented by the government (obligee).*

*Facts:* Under the terms of a bond, in favor of the Government, the surety will answer for the judgment which may be rendered against D (defendant) should he fail to return to the Philippines. The Department of Foreign Affairs banned D from returning to the Philippines.

*Issue:* Is the surety liable under the bond to the Government for failure of D to return to the Philippines?

*Held:* No. In this case, the principal obligation (of returning to the Philippines) has been extinguished by the action of the Government (obligee) in preventing such return. Consequently, the accessory obligation of the surety is likewise extinguished and the bond released of its liability. Article 1266 applies. *(McConn vs. Haragan, 4 SCRA 251 [1962].)*

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7. *Performance of obligation in favor of obligee is prevented by the government.*

*Facts:* Pursuant to a contract, D corporation agreed to act as an agent of N (Naric) in exporting rice and corn (on a no-dollar remittance or barter basis) and in importing certain collateral goods in exchange therefore, and to buy from N the said collateral goods. The charter of N (R.A. No. 633.) authorizes it to engage in barter agreements and to import such goods tax free.

Almost half of the goods were imported and D paid for them as they were received. Because of the change of administration in the government,

barter transactions were suspended. Hence, D was not able to import the remaining collateral goods worth US$480,000.00.

*Issue:* Is D liable to N for the balance of value of the rice and corn exported for its failure to import and buy the collateral goods subject of the contract?

*Held:* No. The obligation of D to import and buy the collateral goods became unenforceable when their importation become legally impossible due to the suspension of barter transactions and the refusal to renew the barter permit by the government of which N (succeeded by the Rice and Corn Administration) was an agency. It was the duty of N to make the necessary representations with the government to enable D to import the remaining collateral goods. The contract has reciprocal stipulations which must be given force and effect.

Consequently, N has no cause of action until it has secured the necessary import permit and it brings in the remaining collateral goods worth US$480,000.00. *(National Rice and Corn Corp. vs. Court of Appeals, 91 SCRA 437 [1979].)*

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8. *The lessee decided to cancel or discontinue with the lease contract "due to financial, as well as technical difficulties."*

*Facts:* In reply to the lessors' (private respondents') letter requesting payment of the first annual rental in the amount of P240,000.00 which was due and payable upon the execution of the contract, lessee (petitioner) argued that under the contract of lease, payment of rental would commence on the date of the isuance of "an industrial clearance" by the (defunct) Ministry of Human Settlements and not from the date of the signing of the contract. The lessors refused to accede to the lessee's request for the pretermination of the contract of lease of the premises to be used as site for a "rock crushing plant and field office, sleeping quarters and canteen/mess hall."

*Issue:* Has the lessee the right to refuse to pay the rentals as stipulated in the contract of lease and to preterminate the contract?

*Held:* (1) *Suspensive condition fulfilled.* — Petitioner was held estopped from claiming that the Temporary Use Permit (valid for 2 years) issued by the Ministry of Human Settlements was not the industrial clearance contemplated in the contract, having considered the permit as industrial clearance and recognized its obligation to pay rentals counted from the date the permit was issued. Moreover, the reason of petitioner in discontinuing with its project and in consequently cancelling the lease contract was 'financial as well as technical difficulties,' not the alleged insufficiency of the Temporary Use Permit.

(2) *Article 1266 not applicable.* — "Invoking Article 1266 and the principles of *rebus sic stantibus*, petitioner asserts that it should be released from the obligatory force of the contract of lease because the purpose of the contract did not materialize due to unforeseen events and causes beyond its control, *i.e.*, due to the abrupt change in political climate after the EDSA Revolution and financial difficulties.

It is a fundamental rule that contracts, once perfected, bind both contracting parties, and obligations arising therefrom have the force of law between the parties and should be complied with in good faith. But the law recognizes exceptions to the principle of the obligatory force of contracts. One exception is laid down in Article 1266 of the Civil Code.

Petitioner cannot, however, successfully take refuge in the said article, since it is applicable only to obligations "to do," and not to obligations "to give." An obligation "to do" includes all kinds of work or service; while an obligation "to give" is a prestation which consists in the delivery of a movable or an immovable thing in order to create a real right, or for the use of the recipient, or for its simple possession, or in order to return it to its owner.

The obligation to pay rentals or deliver the thing in a contract of lease falls within the prestation "to give;" hence, it is not covered within the scope of Article 1266. At any rate, the unforeseen event and causes mentioned by petitioners are not the legal or physical impossibilities contemplated in the said article. Besides, petitioner failed to state specifically the circumstances brought about by "the abrupt change in the political climate in the country except the prevailing uncertainties in government policies on infrastructure projects."

(3) *Article 1267 not applicable.* — "The principle of *rebus sic stantibus* neither fits in with the facts of the case. Under this theory, the parties stipulate in the light of certain prevailing conditions, and once these conditions cease to exist, the contract also ceases to exist. This theory is said to be the basis of Article 1267 of the Civil Code.

This article, which enunciates the doctrine of unforeseen events, is not, however, an absolute application of the principle of *rebus sic stantibus*, which would endanger the security of contractual relations. The parties to the contract must be presumed to have assumed the risks of unfavorable developments. It is therefore only in absolutely exceptional changes of circumstances that equity demands assistance for the debtor.

In this case, petitioner wants this Court to believe that the abrupt change in the political climate of the country after the EDSA Revolution and its poor financial condition "rendered the performance of the lease

contract impractical and inimical to the corporate survival of the petitioner.

This Court cannot subscribe to this argument. x x x Petitioner entered into a contract with private respondents on November 18, 1985. Prior thereto, it is of judicial notice that after the assassination of Senator Aquino on August 21, 1983, the country has experienced political upheavals, turmoils, almost daily mass demonstrations, unprecedented inflation, peace and order deterioration, the Aquino trial and many other things that brought about the hatred of people even against crony corporations. On November 3, 1985, Pres. Marcos, being interviewed live on U.S. television announced that there would be a snap election scheduled for February 7, 1986.

On November 18, 1985, notwithstanding the above, petitioner PNCC entered into the contract of lease with private respondents with open eyes of the deteriorating conditions of the country."

(4) *Pecuniary inability not a defense.* — "Anent petitioner's alleged poor financial condition, the same will neither release petitioner from the binding effect of the contract of lease. As held in *Central Bank vs. Court of Appeals* (139 SCRA 46 [1992].) cited by private respondents, mere pecuniary inability to fulfill an engagement does not discharge a contractual obligation, nor does it constitute a defense to an action for specific performance."

(5) *Motive or particular purpose of lessee in entering into the contract irrelevant.* — "With regard to the non-materialization of petitioner's particular purpose in entering into the contract of lease, *i.e.,* to use the leased premises as a site of a rock crushing plant, the same will not invalidate the contract. The cause or essential purpose in a contact of lease is the use or enjoyment of a thing. As a general principle, the motive or particular purpose of a party in entering into a contract does not affect the validity nor existence of the contract; an exception is when the realization of such motive or particular purpose has been made a condition upon which the contract is made to depend. The exception does not apply here." *(Philippine National Construction Corp. vs. Court of Appeals, 272 SCRA 183 [1997].)*

### Natural impossibility and impossibility in fact distinguished.

In considering the effect of impossibility of performance of a contract on the rights of the parties, it is necessary to keep in mind the distinction between:

(1) *Natural impossibility*, which must consist in the nature of the thing to be done and not in the inability of the party to do so; it must appear that the thing to be done cannot by any means be accomplished; and

(2) *Impossibility in fact*, in the absence of inherent impossibility in the nature of the thing stipulated to be performed, which is only improbable or out of the power of the obligor.

The first class of impossibility goes to the consideration and renders the contract void. The second does not. (17 C.J.S. 951, 952; Reyes vs. Caltex [Phils.], Inc., 84 Phil. 654 [1949].)

EXAMPLES:

(1) Under orders pursuant to a commandeering statute during the World War, the entire product of a manufacturer was taken by the government. It was held that such action excused non-performance of a contract by such manufacturer to supply civilian trade. (40 S. Ct., 5; 253 U.S. 498, 64 Law Ed., 1031, cited in Reyes vs. Caltex [Phils.], Inc., *supra*.)

(2) S obligates himself to deliver certain goods to B. The goods perish through a war or in a shipwreck. Performance is excused, the destruction operating to extinguish the obligation. Here, the doing of the thing which S finds impossible is the foundation of the undertaking.

(3) In the second example, if S is unable to deliver the goods promised and his inability arises not from their destruction but from, say, his inability *to raise money* to buy them due to sickness, typhoon, or the like, his liability is not discharged. In this case, the impossibility partakes of the nature of the risk which S took within the limits of his undertaking of being able to perform. It is a contingency which he could have taken due precaution to guard against in the contract. (Reyes vs. Caltex [Phils.], Inc., *supra*.)

ILLUSTRATIVE CASE:

*Obligation of lessee to pay the rentals corresponding to the period of dispossession resulting by virtue of a mere trespass.*

*Facts:* By virtue of a contract of lease executed on December 23, 1940, R leased to E Corporation two parcels of land for a period of 10 years renewable for another 10 years at the option of the lessee. Upon the entry of Japanese troops in December 1941, they seized the premises and used them through the period of occupation as a sentry post. The officers of lessee corporation being American citizens were interned by the invaders and the said company was closed throughout that period.

After the liberation, E again took over the premises but tendered payment for rent from February 1945 only; it had not paid rent from January 1942.

*Issue:* Has R the right (1) to recover the unpaid rent from January 1942 and (2) to rescind the contract of lease?

*Held:* (1) Yes. E would be relieved from the obligation to pay rent if the subject matter of the lease, were this possible, had disappeared, for the personal occupation of the premises is the foundation of the contract, the consideration that induced E to enter into the agreement. But a mere trespass with which the landlord has nothing to do is a casual disturbance not going to the essence of the undertaking. It is a collateral incident which might have been provided for by a proper stipulation.

(2) No. The failure of E to pay rent during the war was due to impossibility inherent in the nature of the thing to be performed. In this aspect of the contract, the payment of rent was the very thing promised by E, the very foundation, the sole consideration of the contract for R, and E's failure to make good the promise was due to causes over which it had no control and for which it in no manner was at fault. The war led to its officers' incarceration or internment and preventing them from receiving cash from their principal or from working to earn money.

There is no difference in the animating principle involved between this case and that of a promisor who is unable to fulfill a promise to sell a house because the house was burned down. *(Reyes vs. Caltex [Phils.], Inc., supra.)*

*Paras, J., dissenting:* After E had lost possession of the land due to the fact that the Japanese forces seized the same in December 1941, and continuously used it as sentry post during the entire period of the military occupation, and that the officers of E were interned, the latter should be excused from paying the rentals for the period of its dispossession. This is simple justice. It is true that R cannot be blamed for the ejection of E by the Japanese, but this circumstance merely releases R from any liability for damages resulting to E. It cannot warrant the collection by R of the rentals during the period E, without fault, was not in the peaceful enjoyment of the lease.

**ART. 1267. When the service has become so difficult as to be manifestly beyond the contemplation of the parties, the obligor may also be released therefrom, in whole or in part. (n)**

**Effect of difficulty of performance.**

The general rule is that impossibility of performance releases the obligor. (Art. 1266.)

Article 1267 is another exception to the obligatory force of a valid and enforceable contract.

When the performance of the service has become so difficult as to be manifestly beyond the contemplation of both parties, the court is authorized to release the obligor in whole or in part. It would be doing violence to the intention of the parties to hold the obligor still responsible. (see Report of the Code Commission, p. 133.) There is an element of the unforeseen or fortuitous event in the situation covered by Article 1267. (Memorandum of the Code Commission, March 8, 1951, p. 11.)

Note that under Article 1267, the remedy of the obligor is not annulment but to be released from his obligation, in whole or in part.

Article 1267 does not distinguish between an "active" personal obligation to do and a "passive" personal obligation not to do. (see Arts. 1167, 1168.) Despite the use of the term "service," Article 1267 also applies to a real obligation to give or deliver a thing. (see Arts. 1163, 1165.) The term "service" should be understood as referring to the performance of the obligation. (Naga Telephone Co., Inc. vs. Court of Appeals, 230 SCRA 351 [1994].) In a contract of lease, the lessor engages to perform both real and personal obligations. (see Art. 1654.) Article 1266 is applicable only to obligations to do.

In contractual obligations to pay money, Article 1250 applies in case there is an extraordinary increase or decrease in the value of currency stipulated.

EXAMPLE:

X agreed to construct a road near a mountain. A very strong typhoon caused an avalanche making the construction of the road dangerous to human lives. (*Note:* The obligation is not impossible of performance.)

In this case, X may be released, in whole or in part, from his obligation to continue with the construction. (see Labayen vs. Talisay Silay Milling Co., 52 Phil. 440 [1928], *supra.*)

ILLUSTRATIVE CASES:

1. *Examples of causes which will not excuse performance.*

*Facts:* E (LTBC) leased from R the latter's certificates of convenience covering certain transportation lines. The lease contract was approved by the (defunct) Public Service Commission. Subsequently, E filed with the Commission petition for authority to suspend the operation on the lines on the ground of alleged high prices of spare parts and gasoline, and the reduction of its dollar allocations.

During the pendency of the petition, R filed a complaint in the lower court for recovery of rentals in arrears. Meanwhile, the Commission granted E's petition.

*Issue:* Are the causes alleged by E for the suspension of the operation on the lines leased sufficient ground to release E from liability or at least to a reduction of the rentals payable by it?

*Held:* No. Performance is not excused by subsequent inability to perform and by unforeseen difficulties, by unusual or unexpected expenses, by failure of a party to avail himself of the benefits to be had under the contract, by weather conditions, by financial stringency, or by stagnation of business. Neither is performance excused by the fact that the contract turns out to be hard and improvident, unprofitable or impracticable, ill-advised, or even foolish, or less profitable, or unexpectedly burdensome.

Furthermore, it appeared that the alleged causes already existed at the time the contract of lease was executed.[2] They could not, therefore, be ascribed to fortuitous events or circumstances beyond their control, but to E's own voluntary desistance. Finally, "since by the lease, the lessee was to have the advantage of casual profits of the leased premises, he should run the hazard of casual losses during the term and not lay the whole burden upon the lessor." *(Laguna Tayabas Bus Co. vs. Manabat, 58 SCRA 550 [1974].)*

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2. *Contract for the use by the petitioner in the operation of its telephone service of the electric light posts of private respondent has become too disadvantageous to the latter after the contract had been enforced for over 10 years.*

[2]Article 1267 contemplates a situation where the unforeseen difficulty takes place *subsequent* to and was "manifestly beyond the contemplation of the parties" at the time of the making of the contract.

*Facts:* Petitioner N is a telephone company rendering local as well as long distance telephone services in Naga City while private respondent C is a private corporation established for the purpose of operating an electric power service in the same city.

On November 1, 1977, the parties entered into a contract for the use by N in the operation of its telephone service the electric light posts of C in Naga City. In consideration therefor, N agreed to install, free of charge, ten (10) telephone connections for the use by C in specified places.

Said contract also provided:

"(a) That the term or period of this contract shall be as long as the party of the first part [N] has need for the electric posts of the party of the second part [C] it being understood that this contract shall terminate when for any reason whatsoever, the party of the second part is forced to stop, abandoned [sic] its operation as a public service and it becomes necessary to remove the electric lightpost (sic);"

After the contract had been enforced for over ten (10) years, C filed on January 2, 1989 with the Regional Trial Court of Naga City against N for reformation of the contract with damages, on the ground that it is too one-sided in favor of petitioners; that it is not in conformity with the guidelines of the National Electrification Administration (NEA) which direct that the reasonable compensation for the use of the posts is P10.00 per post, per month; that after eleven (11) years of petitioners' use of the posts, the telephone cables strung by them thereon have become much heavier with the increase in the volume of their subscribers, worsened by the fact that their linemen bore holes through the posts at which points those posts were broken during typhoons; that a post now costs as much as P2,630.00; so that justice and equity demand that the contract be reformed to abolish the inequities thereon.

In N's answer, it averred, among others, its utilization of C's post could not have caused their deterioration because they have already been in use for eleven (11) years; and that the value of their expenses for the ten (10) telephone lines long enjoyed by C free of charge are far in excess of the amounts claimed by the latter for the use of the posts, so that if there was any inequity, it was suffered by N.

On the basis of the countervailing evidence of the parties, the trial court found, as regards C's first cause of action, that while the contract appeared to be fair to both parties when it was entered into by them during the first year of C's operation and when its Board of Directors did not yet have any experience in that business, it had become disadvantageous and unfair to C because of subsequent events and conditions, particularly the increase in the volume of the subscribers of N for more than ten (10)

years without the corresponding increase in the number of telephone connections to C free of charge.

The trial court concluded that while in an action for reformation of contract, it cannot make another contract for the parties, it can, however, for reasons of justice and equity, order that the contract be reformed to abolish the inequities therein. Thus, said court ruled that the contract should be reformed by ordering N to pay C compensation for the use of its posts in Naga City, while C should also be ordered to pay the monthly bills for the use of the telephones also in Naga City. And taking into consideration the guidelines of the NEA on the rental of posts by telephone companies and the increase in the costs of such posts, the trial court opined that a monthly rental of P10.00 for each post of C used by N is reasonable, which rental it should pay from the filing of the complaint in this case on January 2, 1989. And in like manner, C should pay N from the same date its monthly bills for the use and transfers of its telephones in Naga City at the same rate that the public are paying.

Disagreeing with the foregoing judgment, N appealed to respondent Court of Appeals. In the decision dated May 28, 1992, respondent court affirmed the decision of the trial court, but based on different grounds to wit: (1) that Article 1267 of the New Civil Code is applicable and (2) that the contract was subject to a potestative condition which rendered said condition void.

N asserts that Article 1267 of the New Civil Code is not applicable primarily because the contract does not involve the rendition of service or a personal prestation and it is not for future service with future unusual change. Instead, the ruling in the case of *Occeña vs. Jabson* (73 SCRA 637 [1976].) which interpreted the article, should be followed in resolving this case.

*Issues*: (1) Does Article 1267 apply to obligations to do?

(2) Is Article 1267 applicable to the case at bar?

*Held:* (1) *Former rule on liability for non-performance modified.* — The case of *Reyes vs. Caltex (Philippines), Inc. (84 Phil. 654 [1949].),* enunciated the doctrine that where a person by his contract charges himself with an obligation possible to be performed, he must perform it, unless its performance is rendered impossible by the act of God, by the law, or by the other party, it being the rule that in case the party desires to be excused from performance in the event of contingencies arising thereto, it is his duty to provide the basis therefor in his contract.

With the enactment of the New Civil Code, a new provision was included therein, namely, Article 1267 which provides: x x x

'In the report of the Code Commission, the rationale behind this innovation was explained, thus:

> 'The general rule is that impossibility of performance releases the obligor. However, it is submitted that when the service has become so difficult as to be manifestly beyond the contemplation of the parties, the court should be authorized to release the obligor in whole or in part. The intention of the parties should govern and if it appears that the service turns out to be so difficult as to have been beyond their contemplation, it would be doing violence to that intention to hold the obligor still responsible.' (p. 133 thereof.)

In other words, fair and square consideration underscores the legal precept therein.''

(2) *Term "service" refers to performance.* — "Article 1267 speaks of 'service' which has become so difficult. Taking into consideration the rationale behind this provision, the term 'service' should be understood as referring to the 'performance' of the obligation. In the present case, the obligation of private respondent consists in allowing petitioners to use its posts in Naga City, which is the service contemplated in said article. Furthermore, a bare reading of this article reveals that it is not a requirement thereunder that the contract be for future service with future unusual change.

According to Senator Arturo M. Tolentino (Commentaries and Jurisprudence on the Civil Code of the Philippines, 1991 Ed., p. 347.), Article 1267 states in our law the *doctrine of unforeseen events.* This is said to be based on the discredited theory of *rebus sic stantibus* in public international law; under this theory, the parties stipulate in the light of certain prevailing conditions, and once these conditions cease to exist the contract also ceases to exist. Considering practical needs and the demands of equity and good faith, the disappearance of the basis of a contract gives rise to a right to relief in favor of the party prejudiced.''

(3) *Contract in question has manifestly become too disadvantageous in favor of C manifestly beyond the contemplation of the parties.* — "In applying Article 1267, respondent court rationalized:

'x x x x x x x x x

That the aforesaid contract has become inequitous or unfavorable or disadvantageous to the plaintiff with the expansion of the business of appellant and the increase in the volume of its subscribers in Naga City and environs through the years, necessitating the stringing of more and bigger telephone cable wires by appellant to plaintiff's electric posts without a corresponding increase in the ten (10) telephone connections given by appellant to plaintiff free of charge in the agreement Exh. 'A' as

consideration for its use of the latter's electric posts in Naga City, appear, however, undisputed from the totality of the evidence on record and the lower court so found. And it was for this reason that in the later (sic) part of 1982 or 1983 (or five or six years after the subject agreement was entered into by the parties), plaintiff's Board of Directors already asked Atty. Luis General who had become their legal counsel in 1982, to study said agreement which they believed had become disadvantageous to their company and to make the proper recommendation, which study Atty. General did, and thereafter, he already recommended to the Board the filing of a court action to reform said contract, but no action was taken on Atty. General's recommendation because the former general managers of plaintiff wanted to adopt a soft approach in discussing the matter with appellant, until, during the term of General Manager Henry Pascual, the latter, after failing to settle the problem with Atty. Luciano Maggay who had become the president and general manager of appellant, already agreed for Atty. General's filing of the present action.

The fact that said contract has become inequitous or disadvantageous to plaintiff as the years went by did not, however, give plaintiff a cause of action for reformation of said contract, for the reasons already pointed out earlier. But this does not mean that plaintiff is completely without a remedy, for we believe that the allegations of its complaint herein and the evidence it has presented sufficiently make out a cause of action under Art. 1267 of the New Civil Code for its release from the agreement in question.

x x x x x x x x x'

In truth, as also correctly found by the lower court, despite the increase in the volume of appellant's subscribers and the corresponding increase in the telephone cables and wires strung by it to plaintiff's electric posts in Naga City for the more than 10 years that the agreement Exh. 'A' of the parties has been in effect, there has been no corresponding increase in the ten (10) telephone units connected by appellant free of charge to plaintiff's offices and other places chosen by plaintiff's general manager which was the only consideration provided for in said agreement for appellant's electric posts outside Naga City although this was not provided for in the agreement Exh. 'A' as it extended and expanded its telephone services to towns outside said city. Hence, while very few of plaintiff's electric posts were being used by appellant in 1977 and they were all in the City of Naga, the number of plaintiff's electric posts that appellant was using in 1989 had jumped to 1,403,192 which are outside Naga City. (Exh. 'B.')

Add to this, the destruction of some of plaintiff's poles during typhoons like the strong typhoon Sisang in 1987 because of the heavy telephone cables attached thereto, and the escalation of the costs of electric

poles from 1977 to 1989, and the conclusion is indeed ineluctable that the agreement Exh. 'A' has already become too one-sided in favor of appellant to the great disadvantage of plaintiff, in short, the continued enforcement of said contract has manifestly gone far beyond the contemplation of plaintiff, so much so that it should now be released therefrom under Art. 1267 of the New Civil Code to avoid appellant's unjust enrichment at its (plaintiff's) expense.

As stated by Tolentino in his commentaries on the Civil Code citing foreign civilist Ruggiero, *equity demands a certain economic equilibrium between the prestation and the counter-prestation, and does not permit the unlimited impoverishment of one party for the benefit of the other by the excessive rigidity of the principle of the obligatory force of contract.* (IV Tolentino, Civil Code of the Philippines, 1986 Ed., pp. 247-248.)" *(Naga Telephone Co., Inc. vs. Court of Appeals, 230 SCRA 351 [1994].)*

**Modification of contract not covered.**

What Article 1267 authorizes is a total or partial release from an obligation, not a modification or revision of the terms and conditions of the contract between the parties. In other words, the court shall either release or not release a party from a contract, but it cannot modify the terms thereof and order the parties to comply with the contract as modified by it.

Hence, even if the situation contemplated by the provision exists, a complaint that seeks not release from the contract but modification of the terms thereof should be dismissed for failure to state a sufficient cause of action. (see Occeña vs. Jabson, 73 SCRA 637 [1976].)

ILLUSTRATIVE CASE:

*Modification of contract is demanded because of increase in prices.*

*Facts:* D (developer) filed a complaint against L (landowner) for modification of a subdivision contract between D and L providing a sharing ratio of 60% for the developer and 40% for the landowner. D cites the worldwide increase in prices.

*Issue:* Does the complaint allege a sufficient cause of action for modification of the contract in question.

*Held:* No. It has no basis in law and must, therefore, be dismissed for failure to state a cause of action. Article 1267 does not authorize the courts *to modify or revise* the subdivision contract between the parties or fix a sharing ratio different from that contractually stipulated with the force of law between the parties, so as to substitute its own terms for those covenanted by the parties themselves.

If D's complaint were to be *released* from having to comply with the subdivision contract, assuming it could show at the trial that the service undertaken contractually by it had "become so difficult as to be manifestly beyond the contemplation of the parties," then the complaint would be justifiable under Article 1207. Without said article, D would remain bound by its contract under the theretofore prevailing doctrine that performance therewith is not excused "by the fact that the contract turns out to be hard and improvident, unjustifiable, or unexpectedly burdensome" (Reyes vs. Caltex [Phils.], Inc., *supra.*), since in case a party desires to be "excused from performance in the event of such contingencies arising, it is his duty to provide therefor in the contract."

But D's complaint seeks not release from the contract but for its modification. Under the particular allegation of D's complaint and the circumstances therein averred, the courts cannot even in equity grant the relief sought. *(Occeña vs. Jabson, 73 SCRA 637 [1976].)*

*Note:* In *Naga (supra.),* the Supreme Court, in holding the inapplicability of *Occeña*, said:

> "In a nutshell, private respondent in the *Occeña* case filed a complaint against petitioner before the trial court praying for *modification* of the terms and conditions of the contract that they entered into by fixing the proper shares that should pertain to them out of the gross proceeds from the sales of subdivided lots. We ordered the dismissal of the complaint therein for failure to state a sufficient cause of action. We rationalized that the Court of Appeals misapplied Article 1267 because:
>
> > 'x x x respondent's complaint seeks *not* release from the subdivision contract but that the court 'render judgment *modifying* the terms and conditions of the contract' . . . by *fixing* the *proper shares* that should *pertain* to the herein parties out of the *gross proceeds* from the sales of subdivided lots of subject subdivision. The cited article (Article 1267.) does not grant the courts (the) authority to remake, modify or revise the contract or to fix the division of shares between the parties as contractually stipulated with the force of law between the parties, so as to substitute its own terms for those covenanted by the parties themselves. Respondent's complaint for modification of contract manifestly has no basis in law and therefore states no cause of action. Under the particular allegations of respondent's complaint and the circumstances therein averred, the courts cannot even in equity grant the relief sought.'

The ruling in the *Occeña* case is not applicable because we agree with respondent court that the allegations in private respondent's complaint and the evidence it has presented sufficiently made out a cause of action under Article 1267. We, therefore, release the parties from their correlative obligations under the contract.

However, our disposition of the present controversy does not end here. We have to take into account the possible consequences of merely releasing the parties therefrom; petitioners will remove the telephone wires/cables in the posts of private respondent, resulting in disrupting of their essential service to the public; while private respondent, in consonance with the contract will return all the telephone units to petitioners, causing prejudice to its business. We shall not allow such eventuality. Rather, we require, as ordered by the trial court: 1) petitioners to pay private respondent for the use of its posts in Naga City and in the towns of Milaor, Canaman, Magarao and Pili, Camarines Sur and in other places where petitioners use private respondent's posts, the sum of Ten (P10.00) pesos per post, per month, beginning January 1989; and 2) private respondent to pay petitioner the monthly dues of all its telephones at the same rate being paid by the public beginning January 1989.

The peculiar circumstances of the present case, as distinguished further from the *Occeña* case, necessitates exercise of our equity jurisdiction. By way of emphasis, we reiterate the rationalization of respondent court that:

> 'x x x In affirming said ruling, we are not making a new contract for the parties herein, but we find it necessary to do so in order not to disrupt the basic and essential services being rendered by both parties herein to the public and to avoid unjust enrichment by appellant at the expense of plaintiff x x x.'"[3]

**ART. 1268. When the debt of a thing certain and determinate proceeds from a criminal offense, the debtor shall not be exempted from the payment of its price, whatever may be the cause for the loss, unless the thing having been offered by him to the person who should receive it, the latter refused without justification to accept it. (1185)**

[3]In novation (Art. 1291.), a contract is modified resulting in its extinguishment and the creation of a new contract; in reformation (Art. 1359.), the same contract is corrected without modification of the terms thereof, its purpose being to make the contract express the true agreement or intention of the parties. Under Article 1267, there is neither modification nor correction of the contract but a party is released therefrom.

**Effect of fortuitous event where obligation proceeds from a criminal offense.**

Article 1268 is another instance where a fortuitous event does not exempt the debtor from liability. (Arts. 1174, 1262.)

The obligation subsists except when the creditor refused to accept the thing (*e.g.*, stolen property), without justification, after it had been offered to him. In such case, the creditor is in *mora accipiendi*. (see Art. 1169.) Consignation is not necessary. The debtor, however, must still exercise due diligence. He is liable for damages if the loss is due to his fault.

**ART. 1269. The obligation having been extinguished by the loss of the thing, the creditor shall have all the rights of action which the debtor may have against third person by reason of the loss. (1186)**

**Right of creditor to proceed against third persons.**

Under the above article, the creditor is given the right to proceed against the third person responsible for the loss. There is no need for an assignment by the debtor. The rights of action of the debtor are transferred to the creditor from the moment the obligation is extinguished, by operation of law to protect the interest of the latter by reason of the loss.

The rule finds frequent application in insurance.[4]

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[4]Art. 2207. If the plaintiff's property has been insured, and he has received indemnity from the insurance company for the injury or loss arising out of the wrong or breach of contract complained of, the insurance company shall be subrogated to the rights of the insured against the wrongdoer or the person who has violated the contract. If the amount paid by the insurance company does not fully cover the injury or loss, the aggrieved party shall be entitled to recover the deficiency from the person causing the loss or injury.

## SECTION 3. — *Condonation or Remission of the Debt*

**ART. 1270. Condonation or remission is essentially gratuitous, and requires the acceptance by the obligor. It may be made expressly or impliedly.**

**One and the other kind shall be subject to the rules which govern inofficious donations. Express condonation shall, furthermore, comply with the forms of donation. (1187)**

### Meaning of condonation or remission.

*Condonation* or *remission* is the gratuitous renunciation by the creditor of his right against the debtor resulting in the extinguishment of the latter's obligation in its entirely or in that part of the same to which the renunciation refers.

It is thus a form of donation.

### Requisites of condonation or remission.

The requisites are the following:

(1) It must be gratuitous;

(2) It must be accepted by the obligor;

(3) The parties must have capacity;

(4) It must not be inofficious; and

(5) If made expressly, it must comply with the forms of donation.

It is also clear that remission, properly speaking, presupposes that the obligation is and continues to be, demandable at the time of the remission. (8 Manresa 365.)

### Evidence required to prove remission.

Remission, being an act of liberality, should be proved by clearer and more convincing evidence than what is required to establish payment. (Villahermosa vs. Medina, [CA] 44 O.G. 4429.)

ILLUSTRATIVE CASE:

*Alleged remission is based on the sole testimony of debtor.*

*Facts:* D executed a promissory note for P500.00 in favor of C. Later, C died. D contends that he did not borrow from C but that the latter acted as intermediary to obtain the loan for D from F, C's friend, and that after he was notified of the death of C, he paid F P200.00 as part payment of the P500.00 loan, offering at the same time to pay the balance in a few days but F made him understand that he was condoning the debt.

*Issue:* Upon the facts, is the alleged remission sufficiently established?

*Held:* No. D was the sole witness who testified about it. F, the creditor, was not presented to confirm it. The promissory note evidencing the debt was never returned by F to C or his legal representative. The partial payment of P200.00 made by D belies the alleged condonation. Moreover, if the said remission were true, it would benefit only the estate of C and not D.

The act of generosity of F must have been towards his friend C whose death bereaved him, or the family of the latter. D had no relation of friendship with F. *(Villahermosa vs. Medina, supra.)*

**Remission must be gratuitous.**

It is an essential characteristic of remission that it be gratuitous, *i.e.*, there is no equivalent received for the benefit given because from the moment it exists, the nature of the act is changed, and becomes:

(1) Dation in payment, if a thing is received by the creditor instead of the amount due (Art. 1245.);

(2) Cession, if the assignment of property is for the benefit of creditors (see Art. 1255.);

(3) Novation, if the object or circumstances of the obligation are changed (Art. 1291.); and

(4) Compromise,[1] if what is renounced is a doubtful or litigious right in exchange of other concessions obtained by the creditor.

[1]Art. 2028. A compromise is a contract whereby the parties, by making reciprocal concessions, avoid a litigation or put an end to one already commenced. (1809a)

**Remission must be accepted by debtor.**

Condonation or remission is a bilateral act. Article 1270 expressly requires its acceptance by the debtor. The necessity of this requisite is explained by the reason that, if the creditor is authorized to impose upon the debtor favors, the remission may be converted into an act of humiliation. (8 Manresa 367.)

The reasons requiring acceptance are fundamental and not limited to any special form. In tacit remission, acceptance must also be shown impliedly. (8 Manresa 370.)

**Renunciation by creditor of his credit.**

Can the creditor renounce his credit even against the will of the debtor? Yes. Such unilateral renunciation is allowed. Article 6 provides that "Rights may be waived, unless the waiver is contrary to law, public order, public policy, morals or good customs, or prejudicial to a third person with a right recognized by law."

Note that Articles 1271 and 1273 speak of "renunciation" and "waiver."

**Kinds of remission.**

They are:

(1) *As to its extent:*

(a) *Complete.* — when it covers the entire obligation;

(b) *Partial.* — when it does not cover the entire obligation.

(2) *As to its form:*

(a) *Express.* — when it is made either verbally or in writing; or

(b) *Implied*. — when it can only be inferred from conduct.

(3) *As to its date of effectivity:*

(a) *Inter vivos.* — when it will take effect during the lifetime of the donor; or

(b) *Mortis causa.* — when it will become effective upon the death of the donor. It must comply with the formalities of a will.[2]

[2]The pertinent provisions of the Civil Code on donation must be noted, particularly Articles 745 to 752, and 771 to 773.

**Effect of inofficious remission.**

While a person may make donations, no one can give more than that which he can give by will, otherwise, the excess shall be inofficious and shall be reduced by the court accordingly.

As a rule, testamentary dispositions which impair the legitime shall be reduced on petition of the heirs (see Art. 887.) insofar as they are inofficious or excessive. (In the matter of the Estate of Don Isidro Aragon, 88 Phil. 107 [1951].) *Legitime* is that part of the testator's property which he cannot dispose of because the law has reserved it for certain heirs (like the children with respect to their parents) who are, therefore, called compulsory heirs. (Art. 886.)

**ART. 1271. The delivery of a private document evidencing a credit, made voluntarily by the creditor to the debtor, implies the renunciation of the action which the former had against the latter.**

**If in order to nullify this waiver it should be claimed to be inofficious, the debtor and his heirs may uphold it by proving that the delivery of the document was made in virtue of payment of the debt. (1188)**

**Presumption in case document of indebtedness voluntarily delivered by creditor.**

(1) *Presumption of implied remission.* — Article 1271 gives an example of implied or tacit remission. In order that the presumption established by this article may be applicable, it is necessary that the delivery of the private document be a voluntary act of the creditor. (Velasco vs. Masa, 10 Phil. 279 [1908].)

If the debt is not yet paid, the creditor would need the document to enforce payment. In case he voluntarily delivers it to the debtor, the only logical inference is that he is renouncing his right.

(2) *Contrary evidence.* — However, evidence is admissible to show otherwise, as when it was delivered only for examination. In a case, the court ruled that there was sufficient evidence that when the plaintiff sent the receipt signed by him to the defendant for the purpose of collecting his attorney's fees, it was not his intention that the document should remain in the possession of the defendant if the latter did not forthwith pay the amount specified therein. (Lopez Lizo vs. Tambunting, 33 Phil. 226 [1916].)

(3) *Extent of remission.* — If the obligation is joint, the presumption of remission, when applicable, pertains only to the share of the debtor who is in possession of the document; if solidary, to the total obligation.

(4) *Presumption applicable only to private document.* — Article 1271 it speaks of a private document. The legal presumption of remission does not apply in the case of a public document because it is easy to obtain a copy of the same, being a public record.

The presumptions in Articles 1271, 1272, and 1274 are only *prima facie.*

### Payment, not remission of debt.

Under the second paragraph of Article 1271, the renunciation of the action which the creditor had against the debtor may be nullified by a showing that the waiver is inofficious. In other words, the remission which the law assumes under the first paragraph becomes null and void upon proof that it is inofficious.

The debtor or his heirs may prove that the delivery of the document was really made in virtue of payment of the debt and not of remission.

**ART. 1272. Whenever the private document in which the debt appears is found in the possession of the debtor, it shall be presumed that the creditor delivered it voluntarily, unless the contrary is proved. (1189)**

### Presumption in case document found in possession of debtor.

Ordinarily, the document evidencing the debt is in the possession of the creditor. He has in his favor the legal presumption that his credit is as yet uncollected, unless the debtor proves satisfactorily, by one of the rules recognized in law, that he has already paid the claim. (Bantug vs. Del Rosario, 11 Phil. 511 [1908]; Merchant vs. International Bank, 9 Phil. 554 [1908]; Behn, Meyer and Co. vs. Rosatsin, 5 Phil. 660 [1906]; Tso Tai Tong Chuache & Co. vs. Insurance Commission, 158 SCRA 366 [1988].)

If the document is later found in the hands of the debtor and it is not known how he came into possession of the same, the presumption is

that it was voluntarily delivered by the creditor. (see Velasco vs. Masa, 10 Phil. 279 [1928].) This presumption of voluntary delivery, in turn, gives rise to the presumption of remission. (Art. 1271.) It is believed, however, that the presumption of voluntary delivery should give rise to the presumption of *payment*, and only *when it is known* that indeed there is no payment should there be a presumption of remission.

EXAMPLE:

D owes C P1,000.00 evidenced by a promissory note. The note, signed by D, is given to C.

If the promissory note is voluntarily delivered to D, the presumption is that the debt must have been paid by D.

If it is known that D has not yet paid C, it must be presumed that the obligation has been remitted by C. (Art. 1271.)

Suppose it is not known how D came into possession of the promissory note. The presumption is that it was voluntarily delivered by C, unless C proves the contrary. (Art. 1272.)

**ART. 1273. The renunciation of the principal debt shall extinguish the accessory obligations; but the waiver of the latter shall leave the former in force. (1190)**

### Effect of renunciation of principal debt on accessory obligation.

The above provision follows the rule that the accessory follows the principal. While the accessory obligations cannot exist without the principal obligation, the latter may exist without the former. (see Art. 1230.)

**ART. 1274. It is presumed that the accessory obligation of pledge has been remitted when the thing pledged, after its delivery to the creditor, is found in the possession of the debtor, or of a third person who owns the thing. (1191a)**

### Presumption in case thing pledged found in possession of debtor.

In a contract of pledge (see Arts. 2085, 2093.), it is necessary that the thing pledged be placed in the possession of the creditor, or of a third person by common agreement. (Art. 2093.) A third person who is not a

party to the principal obligation may secure the latter by pledging his own property. (Art. 2085, last par.)

If the thing pledged is later found in the hands of the debtor or the third person, only the accessory obligation of pledge is presumed remitted, not the obligation itself.[3] The debtor shall continue to be indebted but he does not have to return the thing pledged. The presumption yields to contrary evidence. (see Lao vs. Yek Tong Lin Fire & Marine Ins. Co., 55 Phil. 386 [1930].) It does not arise if the third person in possession of the thing pledged does not own the same.

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[3]Art. 2110. If the thing pledged is returned by the pledgee to the pledgor or owner, the pledge is extinguished. Any stipulation to the contrary shall be void.

If subsequent to the perfection of the pledge, the thing is in the possession of the pledgor or owner, there is a *prima facie* presumption that the same has been returned by the pledgee. This same presumption exists if the thing pledged is in the possession of a third person who has received it from the pledgor or owner after the constitution of the pledge. (n)

# SECTION 4. — *Confusion or Merger of Rights*

**ART. 1275. The obligation is extinguished from the time the characters of creditor and debtor are merged in the same person. (1192a)**

### Meaning of confusion or merger.

*Confusion* or merger is the meeting in one person of the qualities of creditor and debtor with respect to the same obligation. (4 Sanchez Roman 421.)

### Reason or basis for confusion.

(1) The law treats confusion or merger as a mode of extinguishing obligations because if a debtor is his own creditor, enforcement of the obligation becomes absurd since a person cannot claim payment from himself.

(2) Furthermore, when there is a confusion of rights, the purposes for which the obligation may have been created are deemed realized. (see 8 Manresa 388; Sochayseng vs. Trujillo, 31 Phil. 153 [1915].)

### Requisites of confusion.

For a valid confusion or merger to the place, it is necessary that:

(1) It must take place between the principal debtor and creditor; and

(2) It must be complete and definite.

EXAMPLES:

(1) D owes C P1,000.00 for which D executed a negotiable promissory note[1] in favor of C. C indorsed the note to X who, in turn, indorsed it to Y.

[1]Under Section 50 of the Negotiable Instruments Law (Act No. 2031.), where an instrument is negotiated back to a prior party, such party may reissue and further negotiate the same. This may be considered as an exception to the rule in Article 1275.

Now, Y bought goods from the store of D. Instead of paying cash, Y just indorsed the promissory note to D.

Here, D owes himself. Consequently, his obligation is extinguished by merger.

(2) W (wife) has a claim against H (husband) for the support of their children C, etc. Subsequently, W died. H also died later.

Since C, etc. as heirs of W (creditor) are also heirs of H (debtor), the obligation sued upon is extinguished.

(3) C, mortgage-creditor, is the purchaser of the mortgaged property belonging to D, mortgage-debtor, which was sold at public auction after extra-judicial foreclosure. Under ordinary circumstances, if a person has a mortgage credit over a property which was sold in an auction sale, the only right left to him is to collect his mortgage credit from the purchaser, who becomes a debtor to the mortgage-creditor.

In the example, there is a merger between the creditor and debtor in the person of C.

(4) X and Y are the heirs of Z. In his will, Z gave to X a parcel of land in usufruct for ten years. The naked ownership to the same parcel was given to Y. Later, Y sold his interest in the land to X.

In this case, the usufruct is naturally extinguished and X will now have full ownership over the land.

(5) D borrowed money from C. As security, D mortgaged his land. Subsequently, D sold the land to C.

In this case, the mortgage is extinguished, but the obligation subsists. The extinguishment of the accessory obligation does not carry with it that of the principal obligation.

ILLUSTRATIVE CASE:

*Effect where confusion is not complete.*

*Facts:* A, etc., and B, etc., entered into a contract of partnership for the construction of a railroad line between their haciendas. It was agreed that the parties should pay the cost in equal parts. A, etc., were entrusted with the administration of the partnership. While the construction was going on, B, etc., sold their hacienda to C, etc., who obligated themselves "to respect the aforesaid contract and all obligations arising therefrom."

Afterwards, C, etc., bought from A, etc., the 1/2 of the railroad line pertaining to the latter. B, etc., failed to pay 1/2 of the amount expended by A, etc., upon the construction of the railroad line. A, etc., brought action for the recovery of said amount. B, etc., alleged as a defense that their

obligation was extinguished by the merger of the rights of debtor and creditor in C, etc., who assumed the liability of B, etc., and subsequently acquired the credit of A, etc.

*Issue:* Is there a merger of the rights of debtor and creditor in C?

*Held:* None. The rights and titles which A, etc., sold to C, etc., refer only to 1/2 of the railroad line in question. Hence, the credit which they had against B, etc., for the amount of 1/2 of the cost of construction of the said line was not included in the sale. *(Testate Estate of Mota vs. Serra, 47 Phil. 464 [1925].)*

### Extinction of real rights by confusion.

Real rights like usufruct, mortgage, pledge, right of repurchase, lease record, servitude, etc., may be extinguished by merger when any of such rights is merged with ownership which is the most comprehensive real right.

The merger results in what is denominated as *consolidation of ownership*. This may take place by any of the causes which are sufficient to transmit title to an obligation, either by assignment, subrogation, and sale of inheritance. The most important and frequent cause is hereditary succession where the debtor inherits from the creditor, subject to the rights of other creditors. (see 8 Giorgi 164.) It is not, however, strictly a merger in the sense used in Article 1275.

ILLUSTRATIVE CASES:

1. *Mortgagee is purchaser at public auction of mortgaged property sold to satisfy a judgment against the mortgagor in favor of another creditor*.

*Facts:* C held a mortgage credit, in which the property mortgaged was the Steamship Yusingco. This vessel was sold in execution to satisfy a judgment in favor of X. In the execution sale, C bid for and purchased the vessel. From the proceeds of the sale, the judgment in favor of X was paid.

C now seeks to recover what had been paid to X, on the ground that its mortgage credit had preference over the judgment in favor of X.

*Issue:* What is the effect of the purchase by C of the vessel at public auction?

*Held:* After the vessel had been sold in execution, the only right left to C was to collect his mortgage credit from the purchaser thereof at public auction, inasmuch as a mortgage directly and immediately subjects the property on which it is imposed whoever its possessor may be, to the

fulfillment of the obligation for the security of which it was created. It so happens, however, that C cannot take such step in this case, because he was the purchaser of the vessel at public auction, and it was so with full knowledge that he had a mortgage credit on said vessel.

Obligations are extinguished by the merger of the rights of creditor and debtor. Therefore, C's claim may not prosper. *(Yek Tong Lin Fire, etc. vs. Yusingco, 64 Phil. 1062 [1937].)*

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2. *Mortgagee acquires the rights of purchaser at public auction of mortgaged property sold under an execution upon a judgment against the mortgagor in favor of purchaser.*

*Facts:* C filed a suit against X, as administrator of the estate of D, praying for a personal judgment for P30,000.00 with interest and the foreclosure of mortgage securing said debt. This mortgage was a first lien on a parcel of land in question assessed at P28,000.00.

It appeared that C purchased the land from Y who, in turn, purchased the same at a sheriff's sale under an execution upon a judgment against D. The trial court denied the prayer of C.

*Issue:* Is the denial correct?

*Held:* Yes. When C acquired through Y the equity of D in the very same land conveyed to him (C) as mortgagee, a merger of rights took place which had the effect of extinguishing the debt of D in favor of C. If that were not true, C would acquire the legal and equitable title to the land assessed at P28,000.00 for the sum of P857.00 paid by him to Y without giving D or her estate credit for anything, leaving the said estate still owing C the P30,000.00 plus interest, for which the land stood as security.

This extinction of the obligation and merger of rights by which C became the owner of the land, occurred when he acquired the rights of Y. *(Enriquez vs. Rañola, 60 Phil. 561 [1934].)*

**ART. 1276. Merger which takes place in the person of the principal debtor or creditor benefits the guarantors. Confusion which takes place in the person of any of the latter does not extinguish the obligation. (1193)**

## Effect of merger in the person of principal debtor or creditor.

Merger in the person of the principal debtor or creditor extinguishes the obligation. Hence, the accessory obligation of guaranty is also

extinguished in accordance with the principle that the accessory follows the principal.

EXAMPLE:

D is indebted to C with G as guarantor. The merger of the characters of debtor and creditor in D shall free G from liability as guarantor.

Similarly, merger which takes place in the person of C benefits G because the extinction of the principal obligation carries with it that of the accessory obligation of guaranty.

### Effect of merger in the person of guarantor.

The extinguishment of the accessory obligation does not carry with it that of the principal obligation. Consequently, merger which takes place in the person of the guarantor, while it extinguishes the guaranty, leaves the principal obligation in force.

EXAMPLE:

Suppose, in the example above, C assigns his credit to X, who, in turn, assigns the credit to G, the guarantor.

In this case, the contract of guaranty is extinguished. However, D's obligation to pay the principal obligation subsists. G now, as the new creditor, can demand payment from D.

**ART. 1277. Confusion does not extinguish a joint obligation except as regards the share corresponding to the creditor or debtor in whom the two characters concur. (1194)**

### Confusion in a joint obligation.

In a joint obligation, there are as many debts as there are debtors and as many credits as there are creditors, the debts and/or credits being considered distinct and separate from one another. (Art. 1208.)

Each debtor has his own creditor to whom he is liable and confusion taking place in the person of any debtor or creditor does not affect the others. In other words, the confusion will extinguish only the share corresponding to the creditor or debtor in whom the two characters concur. (Art. 1277.)

EXAMPLE:

A, B, and C are jointly liable to D in the amount of P9,000.00 evidenced by a negotiable promissory note. D endorsed the note to E, who, in turn endorsed it to A.

In this case, A's share in the obligation is extinguished because of confusion in his person. However, the indebtedness of B and C in the amount of P3,000.00 each remains because as to them there is no confusion. Consequently, B and C would be liable to A, the new creditor, P3,000.00 each.

### Confusion in a solidary obligation.

Merger in the person of one of the solidary debtors shall extinguish the *entire* obligation because it is also a merger in the other solidary debtors. (Art. 1215.) Remember that in a solidary obligation there is only one obligation and every debtor is individually responsible for the payment of the whole obligation.

He who makes payment may claim *reimbursement* from his co-debtors for the shares which correspond to them. (Art. 1217, par. 2.)

EXAMPLE:

In the example given, if the obligation of A, B, and C is solidary, the endorsement to A extinguishes the entire obligation of P9,000.00. A can demand reimbursement from B and C.

Here, the basis of the right of A is not *the original obligation* which has been extinguished by the confusion which takes place in his person but *the confusion itself.* It is as if A paid the entire debt. He can, therefore, collect the proportionate shares belonging to B and C on an implied contract of reimbursement.

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# SECTION 5. — *Compensation*

**ART. 1278. Compensation shall take place when two persons, in their own right, are creditors and debtors of each other. (1195)**

## Meaning of compensation.

*Compensation* is the extinguishment to the concurrent amount of the debts of two persons who, in their own right, are reciprocally principal debtors and creditors of each other. (Arts. 1278, 1290.)

It involves the simultaneous balancing of two obligations in order to totally extinguish them if they are of the same amount or to the extent in which the amount of one is covered by that of the other, if of different amounts.

EXAMPLE:

A owes B the amount of P1,000.00.

B owes A the amount of P700.00.

Both debts are due and payable today. Here compensation takes place partially, that is, to the concurrent amount of P700.00. So, A shall be liable to B for only P300.00. If the two debts are of the same amount, there is total compensation. (Art. 1281.)

The two debts are extinguished without actual transfer of money between the parties.

## Object and importance of compensation.

The object of compensation is the prevention of unnecessary suits and payments thru the mutual extinction by operation of law of concurring debts. (Nadela vs. Engineering and Construction Corporation, 474 SCRA 168 [2006].)

(1) In effect, compensation is a specie of *abbreviated payment*, which gives to each of the parties a double advantage:

(a) *facility of payment* because it avoids the employment of enumeration; and

(b) *guaranty for the effectiveness of credit*, because if one of the parties pays without waiting to be paid by the other, he could be made a victim of fraud or of insolvency. (G. Florendo, The Law of Obligations and Contracts [1936], p. 424, quoting 2 Castan 61, 62.)

(2) It will be seen that compensation supposes a more convenient and less expensive realization of two payments, meriting, therefore, the name of *simplified payment* by which it is often called.

(3) Compensation is ever more increasing in its application, because the extension and importance of credit and the rapid circulation of credit documents make normal and frequent the situation where two persons become reciprocally creditors and debtors. In this sense, the economic utility of compensation, its advantages for credit and for saving the use of money in transactions, *simplifying accounting,* are such that they have induced the creation of special establishments carrying its name, such as clearing house or *chambre de compensation,* as called by the French.

(4) Compensation serves as *a guaranty against fraud (supra.),* assuring the enforcement of some credits which otherwise may not be enforced; inasmuch as it exists as values in the hands of the creditor conserved, instead of delivered by him. (G. Florendo, *op. cit., supra,* p. 425, quoting 8 Manresa 401.)

**Compensation and confusion distinguished.**

The differences are:

(1) In confusion, there is only one person who is a creditor and debtor of himself, while in compensation, there are two persons involved, each of whom is a debtor and a creditor of the other;

(2) In confusion, there is but one obligation, while in compensation, there are two obligations; and

(3) In confusion, there is impossibility of payment, while in compensation, there is indirect payment.

There may be compensation in joint and solidary obligations. (see Arts. 1207, 1208, 1215.)

**Compensation and payment distinguished.**

The differences are:

(1) Compensation takes effect by operation of law, while payment takes effect by act of the parties;

(2) In compensation, it is not required that the parties have the capacity to give or to receive, as the case may be (Art. 1290.), while in order that there may be a valid payment, the parties must have the free disposal of the thing due and capacity to alienate it (Art. 1239.) and to receive payment (Arts. 1240-1241.), as the case may be; and

(3) In compensation, the law permits partial extinguishment of the obligation (Art. 1281.), while in payment, it is necessary that it be complete (Art. 1233.) and indivisible. (Art. 1248.)

**Compensation and counterclaim distinguished.**

The differences are:

(1) While compensation resembles in many respects the common law set-off and certain counterclaims (see Secs. 6, 9, Rule 6, Rules of Court.), it differs therefrom in that the latter must be pleaded to be effectual, whereas, compensation takes place by mere operation of law, and extinguishes reciprocally the two debts as soon as they exist simultaneously, to the amount of their respective sums (Yap Unki vs. Chua Jamco, 14 Phil. 602 [1929].);

(2) Compensation requires that both debts consist in money, or if the things due are consumable, they be of the same kind and quality (Art. 1279[2].), while in counterclaim, such requirement is not provided; and

(3) Compensation requires that the two debts must be liquidated, while in counterclaim, there is no such requirement.

**Kinds of compensation.**

(1) *By its effect or extent:*

(a) *Total.* — when both obligations are of the same amount and are entirely extinguished (Art. 1281.); or

(b) *Partial*. — when the two obligations are of different

amounts and a balance remains. *(Ibid.)* The extinctive effect of compensation will be partial only as regards the larger debt.

(2) *By its cause or origin:*

(a) *Legal.* — when it takes place by operation of law when all the requisites are present even without the knowledge of the parties (Arts. 1279, 1290.);

(b) *Conventional or voluntary.* — when it takes place by agreement of the parties (Art. 1282.);

(c) *Judicial.* — when it takes place by order from a court in a litigation. (Art. 1283.) Strictly speaking, judicial compensation is merely a form of legal or voluntary compensation when declared by the courts by virtue of an action by one of the parties, who refuses to admit it, and by the defense of the other who invokes it (8 Manresa 403.); or

(d) *Facultative.* — when it can be set up only by one of the parties. (see Arts. 1287, par. 1; 1288.)

**ART. 1279. In order that compensation may be proper, it is necessary:**

**(1) That each one of the obligors be bound principally, and that he be at the same time a principal creditor of the other;**

**(2) That both debts consist in a sum of money, or if the things due are consumable, they be of the same kind, and also of the same quality if the latter has been stated;**

**(3) That the two debts be due;**

**(4) That they be liquidated and demandable;**

**(5) That over neither of them there be any retention or controversy, commenced by third persons and communicated in due time to the debtor. (1196)**

## Requisites of legal compensation.

Article 1270 enumerates the requirements or requisites for legal compensation. Absent any showing that all of these requisites are present, compensation may not take place.

While compensation requires the confluence in the parties of the characters of mutual debtors and creditors, their rights as such creditors and their obligations as such debtors, need not spring from one and

the same contract or transaction. (Mavest [USA], Inc. vs. Sampaguita Government Corporation, 470 SCRA 440 [2005]; Philippine National Bank Madecor vs. Uy, 363 SCRA 128 [2001].)

(1) *The parties are principal creditors and principal debtors of each other. —*

EXAMPLES:

(a) A owes B P10,000.00.

B owes A P10,000.00.

Compensation will take place because A and B are principal debtors and creditors of each other.

(b) A owes B P10,000.00 with C as guarantor.

B owes C P10,000.00.

There will be no compensation between B and C because while B is principally liable to C, C is merely subsidiarily liable to B. Hence, C can demand payment from B.

(c) A owes B P10,000.00.

B owes A P10,000.00, the latter as guardian or administrator.

There will also be no compensation. In this case, A is personally liable to B, while B is not principally liable to A. The real creditor of B is the ward under guardianship or the estate under administration. A is creditor of B in a representative capacity.

(d) A owes B, etc. (partners in partnership P) P10,000.00.

P (partnership) owes A P10,000.00.

A cannot set up compensation because B, etc., are not principally liable to A. (see Escaño vs. Heirs of Escaño, 28 Phil. 73 [1914].)

(e) A (stockholder) owes B (corporation) for the amounts A collected as treasurer of B.

B owes A an amount representing overpayment by A of his stocks.

Compensation was held proper as A and B are mutually debtors and creditors of each other. (Brimo vs. Goldenberg & Co., Inc., 69 Phil. 502 [1940].)

(f) A owes B P10,000.00 in the latter's capacity as administrator of the estate of his (B's) father.

B owes A P10,000.00 representing debt of B's father.

Compensation was held proper because the credit of A is chargeable against the estate under B's administration. (see De la Peña vs. Hidalgo, 20 Phil. 323 [1911].)

ILLUSTRATIVE CASES:

1. *A stockholder seeks to compensate his indebtedness to a corporation for the value of his shares.*

*Facts:* S is a stockholder in X Corporation which filed a complaint for the recovery of an indebtedness of S.

*Issue:* Is it proper to compensate S's indebtedness to X Corporation with the sum representing the value of S's shares of stock with X Corporation?

*Held:* No. A share of stock or certificate thereof is not an indebtedness to the owner nor evidence of indebtedness and, therefore, it is not a credit. Stockholders, as such, are not creditors of the corporation for the value of their shares of stock. The capital stock of the corporation is a trust fund to be used more particularly for the security of creditors of the corporation, who presumably deal with it on the credit of its capital stock.

Therefore, S, not being a creditor of X Corporation, although the latter is a creditor of the former, there is no sufficient ground to justify a compensation. *(Garcia vs. Lim Chu Seng, 57 Phil. 562 [1932].)*

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2. *On the same date that the corporation obtained the amount of the letter of credit from the bank, it paid a marginal deposit to the latter.*

*Facts:* Respondent CC Corporation obtained from petitioner CB (bank) a letter of credit in the amount of P1,068,150.00. On the same date, CC paid a marginal deposit of P320,445.00 to CB. The letter of credit was used to purchase banker fuel oil from P corporation, which the latter delivered directly to CC. In relation to the same transaction, a trust receipt for the amount of P1,001,520.93 was executed by CC with respondent L as signatory.

In this case, the delivery to CC of the goods subject of the trust receipt occurred before the trust receipt itself was executed. Since ownership over the goods was already transferred to CC (debtor) prior to the date of the execution of the trust receipt, the transaction was held a simple loan and not a trust receipt agreement.

CB contends that the marginal deposit made by CC should not be deducted outright from the amount of the letter of credit.

*Issue:* Should the marginal deposit be considered only after computing the principal plus accrued interests and other charges?

*Held:* No. "To sustain petitioner on this score, would be to countenance a clear case of unjust enrichment, for while a marginal deposit earns no interest in favor of the debtor-depositor, the bank is not only able to use the same for its own purposes, interest-free, but is also able to earn interest on the money loaned to respondent Corporation. Indeed, it would be onerous to compute interest and other charges on the face value of the letter of credit which the petitioner issued, without first crediting or setting off the marginal deposit which the respondent Corporation paid to it.

Compensation is proper and should take effect by operation of law because the requisites in Article 1279 of the Civil Code are present and should extinguish both debts to the concurrent amount. Hence, the interests and other charges on the subject letter of credit should be computed only on the balance of P681,075.93, which was the portion actually loaned by the bank to respondent Corporation." *(Consolidated Bank and Trust Corporation vs. Court of Appeals, 356 SCRA 671 [2001].)*

(2) *Both debts consist in a sum of money, or of consumable things*[1] *of the same kind and quality. —*

EXAMPLES:

(a) A owes B P10,000.00.

B owes A an electric range worth P10,000.00.

No compensation will take place. (see Arts. 1244, 1246.)

(b) A obliged himself to deliver to B 10 sacks of rice while B obliged himself to deliver to A 10 sacks of corn.

Compensation will not also take place because the things due are not of the same kind. Neither will there be compensation if the obligation of A is to deliver 10 sacks of "macan" rice while that of B, is to deliver 10 sacks of *"wagwag"* rice.

(c) A owes B 10 sacks of *"wagwag"* rice.

B owes A any 10 sacks of rice.

There can be no legal compensation in this case because of the lack of identity of the kind and quality of the rice due. Compensation can be

[1]They are "movables which cannot be used in a manner appropriate to their nature without their being consumed." (Art. 418.) Even non-consumable things may be compensated provided they are of the same kind and quality. The law seems to refer to what are called "fungible" things or things of such kind and nature that they are capable of being substituted for each other. The new Civil Code in Article 418 changed the old classification of goods from fungible and non-fungible (Art. 334, old Civil Code.) into consumable and non-consumable.

claimed by B since he can deliver any kind of rice. It would be the same as if B received 10 sacks of *"wagwag"* rice from A and then returned the same to A in payment of his debt. But A cannot set up compensation if opposed by B. This is an example of *facultative* compensation. (see Arts. 1287, 1288.)

(d) A owes B a specific horse.

B owes A another specific horse.

Compensation cannot be set up by A or B (see Art. 1244.), unless both agree. (Art. 1282.)

(e) A owes B any horse.

B owes A any horse.

Compensation will take place in this case, although the things due are not consumable since the things due are of the same kind. As to their quality, Article 1246 governs.

(f) A owes B P10,000.00

B owes A P10,000.00 or a cow.

There can be no legal compensation because B may prefer to deliver a cow. But if the right of choice belongs to A, compensation will take place.

(3) *The two debts are due or demandable.* — Both debts must also be due or demandable at the same time, *e.g.*, their performance can be enforced in court, although incurred at different dates.

(a) When the obligation is payable on demand, the obligation is not yet due where no demand has not been made.

(b) A debt that has prescribed is no longer demandable and consequently, cannot be compensated (see Montilla vs. Augustinian Corp., 25 Phil. 447 [1913].) unless the compensation has taken place before the lapse of the period of prescription.

(c) Natural obligations are not legally demandable. (see Arts. 1423.)

EXAMPLES:

(a) A owes B P10,000 due today.

B owes A P10,000 payable upon receipt from A of notice to pay.

A owes C a judgment debt of P10,000.

(b) Since B's obligation appear to be payable on demand, in the absence of demand made by A, the obligation of B is not yet due. Without compensation having taking place, B remains indebted to A for P10,000. This obligation of B may be garnished (see Art. 1293.) in favor of C to satisfy A's judgment debt.

A owes B P10,000.00 due today.

B owes A P10,000.00 due next month.

Compensation cannot take place as the debts are not due on the same date. However, if A has not yet paid B on the date that the obligation of B becomes due, there will be compensation on that date. If the debt of B is subject to a suspensive condition which has not yet happened, there can also be no compensation.

(4) *The two debts are liquidated.* — A debt is liquidated if the amount thereof is known or can be determined by a simple computation.

(a) Proof of the liquidation of a claim in order that there be compensation of debts, is necessary if such claim is disputed. Thus, compensation cannot extend to unliquidated, disputed claim existing from breach of contract.[2] (Silahis Marketing Corp. & Intermediate Appellate Court, 180 SCRA 21 [1989].)

(b) If the claim is undisputed, the statement is sufficient and no other proof may be required. (Republic vs. De los Angeles, 98 SCRA 103 [1980]; see Pioneer Insurance and Surety Co. vs. Court of Appeals, 180 SCRA 156 [1989].)

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[2]A distinction must be made between a debt and a mere claim. A debt is an amount actually ascertained. It is a claim which has been formally passed upon by the courts or quasi-judicial bodies to which it can in law be submitted and has been declared to be a debt. A claim, on the other hand, is a debt in embryo. It is a mere evidence of a debt and must pass thru the process prescribed by law before it develops into what is properly called a debt. (Vallarta vs. Court of Appeals, 163 SCRA 587 [1988]; E.G.V. Realty Development Corp. vs. Court of Appeals, 310 SCRA 657 [1997]; Republic v. Sandiganbayan, 346 SCRA 760 [2000].) Unless admitted by a debtor himself or pronounced by final judgment of a competent court or body, no compensation or set-off can take place involving a mere claim. Thus, it has been held that to warrant the application of set-off under Article 1278, the debtor's admission of his obligation must be clear and categorical, and not one which merely arises by inference or implication such as from the customary execution of official documents by a public officer in assuming the responsibilities of a predecessor in office. Neither would his signature in the list of unaccounted properties operate as an acknowledgment of an obligation. There must be an independent evidence showing his intention to unmistakably recognize his indebtedness. (Bangko Sentral ng Pilipinas vs. Commission on Audit, 479 SCRA 544 [2006]; see Premiere Development Bank vs. Flores, 574 SCRA 66 [2008].)

(c) A party may set up unliquidated debts or damages as counterclaim in his answer to the other party's claim. (Art. 1283; see Rules of Court, Rule 9, Sec. 2.)

EXAMPLES:

(a) A owes B P10,000.00.

B owes A the share of the latter in a business the amount of which is still to be ascertained.

Compensation will not take place as the debt of B is not liquidated. If part of the debt of B has been liquidated, compensation takes place with respect to that part without waiting for the liquidation of the rest. (see Art. 1248.)

(b) B (bank) is indebted to P in the amount of P100,000.00 representing his money market investment. B contends that after foreclosing the mortgage executed by P to secure a loan extended to him, there is still due from P as deficiency the amount of P500,000.00 against which B has the right to apply or set off P's money market investment. The validity of the extra-judicial foreclosure sale and B's claim for deficiency are still pending consideration in the Regional Trial Court in the case for annulment of the sheriff's filed by P.

Legal compensation cannot take place as the requirement that the debts must be liquidated and demandable is not present. (International Corporate Bank vs. Intermediate Appellate Court, 163 SCRA 296 [1988].)

(c) D has a savings account with B (bank) which extended to D a loan. D's promissory notes had matured and become demandable. His savings account is also demandable anytime. In this case, B is the creditor of D for his outstanding loan. At the same time, D is the creditor of B as far as his deposit account is concerned, since bank deposits, whether fixed, savings, or current, should be considered as simple loan or *mutuum* by the depositor to the bank. (Art. 1980.) B has the right to compensate or off-set D's outstanding loan with his deposit account. (Citibank, N.A. vs. Sabeniano, 504 SCRA 378 [2006].)

ILLUSTRATIVE CASES:

1. *A party to a case retained the amount awarded in a judgment against another which is still on appeal by the latter.*

*Facts:* A judgment for P75,000 was obtained against D by C. Pending appeal of such judgment by D, C secured the issuance of a writ of execution as D did not furnish a supersedeas bond. Certain properties of D were sold by the sheriff in due course.

The appellate court reduced the amount awarded to P46,000.00. Pursuant to such modified decision, C returned to D the difference between the sum already collected (through execution pending appeal), and the amount allowed by the court, after deducting among others, P2,000, "the amount retained by C for having secured another judgment against D, although D appealed from it and the case is pending hearing."

D moved for the return of P2,000.00. C opposed on the ground that "although it is true that D appealed from the decision of the trial court which sentenced him to pay P2,000.00, compensation had taken place, and unless the Court of Appeals reverses said decision, C has the right to retain the said sum."

*Issue:* Has compensation taken place in this case as contended by B?

*Held:* No. The claim of C is still being the subject of court litigation. It is a requirement for compensation to take place, that the amount involved be certain and liquidated. In this case, the amount awarded to C is not yet liquidated. (*Miailhe vs. Halili, 6 SCRA 453 [1962];* see also Solinap vs. Del Rosario, 123 SCRA 640 [1983].)

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2. *One of the debts is not yet liquidated for there is a running interest still to be paid thereon.*

*Facts:* A charter contract was entered into between C (charterer) and O (owner) of a vessel with C given the option to purchase the vessel. C shall "cause the repair of the vessel, advancing the cost of labor and drydocking thereof, and O to furnish the necessary spare parts. The vessel was later judicially adjudicated to T and C was divested of possession.

O and T were declared solidarily liable to C for reimbursement of the useful and necessary expenses incurred on the vessel amounting to P40,797.54 with legal interest thereon computed from the date of C's dispossession on February 3, 1951 until fully paid but the unpaid rentals amounting to P59,500.00 due O were deductible from the amount payable to C. O claimed compensation took place on February 3, 1951."

*Issue:* Did compensation take place between O and C as of February 3, 1951, the date the latter was dispossessed of the vessel?

*Held:* No. The legal interest payable from said date on the sum of P40,797.54 representing useful expenses incurred by C was also still unliquidated since interest does not stop accruing "until the expenses are fully paid." To the said sum will still have to be added the legal rate of interest "from February 3, 1951 until fully paid." *(Compania Maritima vs. Court of Appeals, 135 SCRA 593 [1985].)*

(5) *No retention or controversy has been commenced by a third person.* — This is a negative requisite for legal compensation. The other such requisite is that the compensation is not prohibited by law. (Arts. 1287, 1288.) Of course, compensation will not take place where there is waiver. There is said to be a retention when the credit of one of the parties is subject to the satisfaction of the claim of a third person, while a controversy exists when a third person claims he is the creditor of one of the parties.

The retention or controversy commenced by a third person must be communicated "in due time" to the debtor. By "in due time" means the period before legal compensation is supposed to take place, considering that legal compensation operates so long as the requisites concur even without any conscious intent on the part of the parties. A controversy that is communicated to the parties after that time may no longer undo the compensation that had taken place by force of law. (PNB Madecor vs. Uy, 363 SCRA 128 [2001].)

EXAMPLE:

A owes B P10,000.00.

B owes A P10,000.00.

B also owes C P10,000.00.

C causes the garnishment of the credit of B against A and notifies A not to pay B P10,000.00 as C has a better right to the said amount.

B may not owe C but the latter claims that he and not B is the creditor of A.

In this case, compensation cannot take place between A and in view of a controversy commenced by C, a third person. In the meantime, the compensation is suspended.

If C loses the case, compensation shall be deemed to have taken place as of the date the requisites for legal compensation concurred.

ILLUSTRATIVE CASE:

*Third person whose claim against one of the parties is not superior to that of the other party, objects to compensation.*

*Facts:* The court set off the claim of A amounting to P7,000.00 with B's claim in the sum of P8,000.00 and ordered A to pay the balance of P1,000.00 to B, with legal interest. A's attorneys claimed that they have a lien on the judgment in favor of A and, therefore, the lower court committed error in ordering the set-off without such lien being fully satisfied.

*Issue:* Is this claim tenable?

*Held:* No. If it be just that A should collect the amount owing him by B, as determined by final decision, it is equally just that B should have the right to collect the sum which A owes him, according to the same decision; therefore, in order to comply with such decision, determining the two liabilities directly opposed to each other, it consequently and logically follows that a set-off of both credits up to a concurrent amount, must be effected; and if the lien, or the right to collect professional fees on the part of the attorneys (see Sec. 37, Rule 138, Rules of Court.), were superior to the right of B, the creditor of A, the result would be that the executory decision would not be complied with.

There would then be no set-off and B would be compelled to pay A his debt through the aforementioned lien of the intervening attorneys but could not collect, nor apply to the payment of the credit owing him by A, the amount of his debt to the latter. This would be illegal and opposed to the most rudimentary principle of justice and furthermore, would be an absurdity and contrary to common sense. *(De La Peña vs. Hidalgo, 20 Phil. 323 [1911].)*

**Compensation against the government.**

(1) *Taxes.* — As a general rule, taxes, being obligations of public interest, and governed by special laws, are not subject to set-off or compensation. They are not in the nature of contracts but grow out of a duty to the Government, to the making and enforcing of which the personal consent of the individual taxpayers is not required. (see 47 Am. Jur. 766-767; Republic vs. Mambulao Lumber Co., 4 SCRA 622 [1962]; Francia vs. Intermediate Appellate Court, 162 SCRA 753 [1988].)

An exception is where both the claims of the government and the taxpayer against each other have already become due and demandable as well as fully liquidated. Thus, a taxpayer, who has been assessed municipal taxes may assign in favor of the municipality a final judgment obtained by him against the said municipality to cover the assessed taxes. (see Domingo vs. Garlitos, 8 SCRA 443 [1963].)

(2) *Contractual obligations.* — Contractual obligations of the government may be compensated. However, in view of rules or regulations relating to public finance, both claims must involve the same office, agency or subdivision of the government.

ILLUSTRATIVE CASE:

*Taxpayer corporation posits the theory that it has no obligation to pay existing excise tax liabilities within the prescribed period since it still has pending claims for VAT input credit/refund with the Bureau of Internal Revenue (BIR).*

*Facts:* Petitioner PMC (Philex) assails the decision of the Court of Appeals affirming the Court of Tax Appeals' decision ordering it to pay more than P110 million as excise tax liability, plus 20% annual interest pursuant to Sections 248 and 249 of the National Internal Revenue Code.

PMC protested the demand by the BIR for payment of its excise tax liabilities stating that it has pending claims for VAT input credit/refund. Therefore, these claims should be applied against the tax liabilities. The position of the BIR is that since these pending claims had not yet been established or determined with certainty, it follows that no legal compensation can take place.

Subsequently, PMC was able to obtain its VAT input credit/refund. It now contends that the same should, *ipso jure* offset its excise tax liabilities, since both had already become "due and demandable, as well as fully liquidated." Hence, legal compensation can properly take place.

*Issue:* May a pending claim for credit/refund be set-off against an existing tax liability even though the claim has not yet been approved by the Commissioner of Internal Revenue?

*Held:* No. (1) *Taxes not subject to compensation.* — "Taxes cannot be the subject to compensation for the simple reason that the government and the taxpayer are not creditors and debtors of each other. There is a material distinction between a tax and debt. Debts are due to the Government in its corporate capacity, while taxes are due to the Government in its sovereign capacity.

There can be no off-setting of taxes against the claims that the taxpayer may have against the government. A person cannot refuse to pay a tax on the ground that the government owes him an amount equal to or greater than the tax being collected. The collection of a tax cannot await the results of a lawsuits against the government."

(2) *Distinguishing feature of a tax.* — "A distinguishing feature of a tax is that it is compulsory rather than a matter of bargain. Hence, a tax does not depend upon the consent of the taxpayer. If any taxpayer can defer the payment of taxes by raising the defense that it still has a pending claim for refund or credit, this would adversely affect the government revenue system. A taxpayer cannot refuse to pay his taxes when they fall due simply because he has a claim against the government or that the collection of the tax is contingent on the result of the lawsuit it filed against the government.

Moreover, Philex's theory that would automatically apply its VAT input credit/refund against its tax liabilities can easily give rise to confusion and abuse, depriving the government of authority over the manner by which taxpayers credit and offset their tax liabilities."

(3) *Payment of surcharge mandatory.* — "Corollarily, the fact that Philex has pending claims for VAT input claim/refund with the government is immaterial for the imposition of charges and penalties prescribed under Sections 248 and 249 of the Tax Code of 1977. The payment of the surcharge is mandatory and the BIR is not vested with any authority to waive the collection thereof. The same cannot be condoned for flimsy reasons, similar to the one advanced by Philex in justifying its non-payment of is tax liabilities."

(4) *Remedy of taxpayer.* — "A taxpayer is not devoid of remedy against BIR examiners who take time in acting upon the taxpayer's claim for refund. First, he can seek judicial remedy before the Court of Tax Appeals in the manner prescribed by law. Second, if the inaction can be characterized as willful neglect of duty, then recourse under Article 27 of the Civil Code and more, importantly, Section 269(c) of the National Internal Revenue Code may be availed of." *(Philex Mining Corporation vs. Commissioner of Internal Revenue, 294 SCRA 687 [1998].)*

**ART. 1280. Notwithstanding the provisions of the preceding article, the guarantor may set up compensation as regards what the creditor may owe the principal debtor. (1197)**

### Compensation benefits guarantor.

This article is an exception to the general rule that only the principal debtor can set up against his creditor what the latter owes him.

Although the guarantor is only subsidiarily, not principally bound, he is given the right to set up compensation. The reason is that the extinguishment of the principal obligation as a consequence of compensation carries with it the accessory obligations such as guaranty. (see Arts. 1230, 1273, 1276, 1296.)

**ART. 1281. Compensation may be total or partial. When the two debts are of the same amount, there is a total compensation. (n)**

### Total and partial compensations.

Total or partial compensation applies to all the different kinds of compensation. (see example under Article 278.)

Total compensation results when the two debts are of the same amount. (Art. 1281.) If they are of different amounts, compensation is total as regards the smaller debt, and partial only with respect to the larger debt. *(supra.)*

**ART. 1282. The parties may agree upon the compensation of debts which are not yet due. (n)**

### Voluntary compensation.

This provision of law is an exception to the general rule that only debts which are due and demandable can be compensated. (Art. 1279[3, 4].)

Voluntary or conventional compensation includes any compensation which takes place by agreement of the parties even if all the requisites for legal compensation are not present. This kind of compensation has no special requisites. It is sufficient that the contract of the parties, which declares the compensation, is valid. (Art. 1306.) Thus, the absence of mutual creditor-debtor relation cannot negate the conventional compensation.

The only requisites are: (1) each of the parties has the right to dispose of the credit he seeks to compensate, and (2) they agree to the mutual extinguishment of their credits. (CKH Industrial & Development Corp. vs. Court of Appeals, 272 SCRA 333 [1997], citing IV Tolentino, Civil Code of the Phils., 1985 Ed., p. 368; United Planters Sugar Milling Co., Inc. vs. Court of Appeals, 527 SCRA 336 [2007].)

**ART. 1283. If one of the parties to a suit over an obligation has a claim for damages against the other, the former may set it off by proving his right to said damages and the amount thereof. (n)**

### Judicial compensation.

Compensation may also take place when so declared by a final judgment of a court in a suit. A party may set off his claim for damages against his obligation to the other party by proving his right to said damages and the amount thereof.

Both parties must prove their respective claims. In the absence from both parties on their claims, offsetting is improper. The right to

offset may exist but the question of how much is to be offset is factual in nature. (Ramel vs. Aquino, 497 SCRA 170 [2006].)

A set-off or counterclaim is different from compensation. The first must be pleaded to be effectual, whereas the second takes place by mere operation of law. (Yap Unki vs. Chua Jamco, 14 Phil. 602 [1909]; see Secs. 3, 4, Rule 9, Rules of Court.)

**ART. 1284. When one or both debts are rescissible or voidable, they may be compensated against each other before they are judicially rescinded or avoided. (n)**

### Compensation of rescissible or voidable debts.

Rescissible (Art. 1381.) and voidable obligations (Art. 1390.) are valid until they are judicially rescinded or avoided. Prior to rescission or annulment, the debts may be compensated against each other.

EXAMPLE:

A owes B P10,000.00. Subsequently, A, through fraud was able to make B sign a promissory note that B is indebted to A for the same amount.

The debt of A is valid but that of B is voidable. Before the debt of B is nullified, both debts may be compensated against each other if all the requisites for legal compensation are present. (Art. 1279.)

Suppose B's debt is later on annulled by the court, is A still liable considering that compensation had already taken place? Yes. The effect of the annulment is retroactive. It is the same as if there had been no compensation.

**ART. 1285. The debtor who has consented to the assignment of rights made by a creditor in favor of a third person, cannot set up against the assignee the compensation which would pertain to him against the assignor, unless the assignor was notified by the debtor at the time he gave his consent, that he reserved his right to the compensation.**

**If the creditor communicated the cession to him but the debtor did not consent thereto, the latter may set up the compensation of debts previous to the cession, but not of subsequent ones.**

**If the assignment is made without the knowledge of the debtor, he may set up the compensation of all credits prior to the same and also later ones until he had knowledge of the assignment. (1198a)**

### Where compensation has taken place before assignment.

When compensation takes effect by operation of law or automatically, the debts are extinguished to the concurrent amount. (Art. 1290.) If subsequently, the extinguished debt is assigned by the creditor to a third person, the debtor can raise the defense of compensation with respect to the debt. It is well-settled that the rights of the assignee are not any greater than the rights of the assignor since the assignee is merely substituted in the place of the assignor.

The remedy of the assignee is against the assignor. Of course, the right to the compensation may be waived by the debtor before or after the assignment.

EXAMPLE:

A owes B P3,000.00 due yesterday.

B owes A P1,000.00 due also yesterday.

Both debts are extinguished up to the amount of P1,000.00. Hence, A still owes B P2,000.00 today.

Now, if B assigns his right to C, the latter can collect only P2,000.00 from A.

However, if A gave his consent to the assignment before it was made or subsequently (par. 1.), A loses the right to set up the defense of compensation. So A will be liable to C for P3,000.00 but he can still collect the P1,000.00 owed by B. In other words, the compensation shall be deemed not to have taken place.

### Where compensation has taken place after assignment.

Article 1285 speaks of three cases of compensation which take place after an assignment of rights made by the creditor: one, where the assignment is made with the consent of the debtor (par. 1.); another, in which the assignment is made without the consent but with the knowledge of the debtor (par. 2.); and the third, is one in which the assignment is without the knowledge of the debtor. (par. 3.)

(1) *Assignment with the consent of debtor. —*

EXAMPLE:

A owes B P3,000.00 due November 15.

B owes A P1,000.00 due November 15.

B assigned his right to C on November 1 with the consent of A.

On November 15, A cannot set up against C, the assignee, the compensation which would pertain to him against B, the assignor. In other words, A is liable to C for P3,000.00 but he can still collect the P1,000.00 debt of B.

However, if A, while consenting to the assignment, reserved his right to the compensation, he would be liable only for P2,000.00 to C. (par. 1.)

(2) *Assignment with the knowledge but without the consent of debtor. —*

EXAMPLE:

A owes B P1,000.00 due November 1.

B owes A P2,000.00 due November 10.

A owes B P1,000.00 due November 15.

A assigned his right to C on November 12. A notified B but the latter did not give his consent to the assignment. How much can C collect from B?

B can set up the compensation of debts on November 10 which was before the cession on November 12. (par. 2.) There being partial compensation, the assignment is valid only up to the amount of P1,000.00.

But B cannot raise the defense of compensation with respect to the debt of A due on November 15 which has not yet matured. So, on November 12, B is liable to C for P1,000.00. Come November 15, A will be liable for his debt of P1,000.00 to B.

The amendment of the second paragraph of Article 1285 has been proposed in such a way as to make the determining point of time not the act of cession itself but the receipt of the notice of the cession, as this is more in consonance with the rule stated in Article 1626.[3] (see

[3]Art. 1626. The debtor who, before having knowledge of the assignment, pays his creditor shall be released from the obligation. (1527)

J.B.L. Reyes, Observation on the New Civil Code, XVI L.J., p. 49, Jan. 31, 1951.)

(3) *Assignment without the knowledge of the debtor.* —

EXAMPLE:

In the preceding example, let us suppose that the assignment was made without the knowledge of B who learned of the assignment only on November 16.

In this case, B can set up the compensation of credits before and after the assignment. The crucial time is when B acquired knowledge of the assignment and not the date of the assignment. If B learned of the assignment after the debts had already matured, he can raise the defense of compensation; otherwise, he cannot.

**ART. 1286. Compensation takes place by operation of law, even though the debts may be payable at different places, but there shall be an indemnity for expenses of exchange or transportation to the place of payment. (1199a)**

## Compensation where debts payable at different places.

This article applies to legal compensation. The indemnity contemplated above does not refer to the difference in the value of the things in their respective places but to the expenses of monetary exchange (in case of money debts) and expenses of transportation (in case of things to be delivered). Once these expenses are liquidated, the debts also become compensable. The indemnity shall be paid by the person who raises the defense of compensation.

*Foreign exchange* has been defined as the conversion of an amount of money or currency of one country into an equivalent amount of money or currency of another.[4] (Belman Compania Incorporada vs. Central Bank, 104 Phil. 877 [1958]; Janda vs. Lepanto Consolidated Mining Co., 99 Phil. 197 [1956].)

[4]*Exchange rate* is the price of one currency expressed or quoted in relation to another currency. In the Philippines, the exchange rate is traditionally expressed as the value of one U.S. dollar in terms of the Philippine peso. Under a floating exchange rate system, the value of the dollar *vis-á-vis* the pesos is determined by the forces of supply and demand, while under a fixed exchange rate system, the par value rate between the two currencies is set by the Central Bank which may adjust it from time to time.

EXAMPLES:

(1) A owes B $1,000.00 payable in New York. B owes A P28,000.00 (equivalent amount) payable in Manila.

If A claims compensation, he must pay for the expenses of exchange.

(2) A obliged himself to deliver to B 100 sacks of rice in Davao. B is also bound to deliver to A 100 sacks of rice of the same kind in Bulacan. The expenses for transportation of the rice to Davao amount to P4,000.00 and to Bulacan, P1,000.00.

If A claims compensation, he must indemnify B the amount of P3,000.00 for the expenses of transportation of the rice to Davao.

**ART. 1287. Compensation shall not be proper when one of the debts arises from a depositum or from the obligations of a depositary or of a bailee in commodatum.**

**Neither can compensation be set up against a creditor who has a claim for support due by gratuitous title, without prejudice to the provisions of paragraph 2 of Article 301. (1200a)**

**ART. 1288. Neither shall there be compensation if one of the debts consists in civil liability arising from a penal offense. (n)**

## Instances when legal compensation not allowed by law.

(1) *Where one of the debts arises from a depositum.* — A deposit is constituted from the moment a person receives a thing belonging to another with the obligation of safely keeping it and of returning the same. (Art. 1962.)

Article 1287 uses the word *depositum* instead of "deposit" which is used for an ordinary bank deposit. A bank deposit is not a *depositum* as defined above. It is really a loan which creates the relationship of debtor and creditor. As a general rule, a bank has a right of set-off of the deposits in its hands for the payment of any indebtedness to it on the part of a depositor. (Gullas vs. Phil. National Bank, 62 Phil. 519 [1935].) Similarly, a depositor has every right to set-off his money deposit with a bank against the loans he had obtained from said bank. (Republic vs. Court of Appeals, 65 SCRA 186 [1975].)

EXAMPLE:

A owes B P1,000.00. B, in turn, owes A the amount of P1,000.00 representing the value of a ring deposited by A with B, which B failed to return.

In this case, B, who is the depositary, cannot claim legal compensation even if A fails to pay his obligation. The remedy of B is to file an action against A for the recovery of the amount of P1,000.00.

The relation of the depositary to the depositor is fiduciary in character since it is based on trust and confidence. B's claim for compensation against A would involve a breach of that confidence.

But A can set up his deposit by way of compensation against B's credit. This is an example of facultative compensation. (also Nos. 2 and 4, *infra.*) The benefit granted by law is available only to A, as depositor, and can be waived by him. (see Art. 6.)

(2) *Where one of the debts arises from a commodatum. — Commodatum* is a gratuitous contract whereby one of the parties delivers to another something not consumable so that the latter may use the same for a certain time and return it. (Art. 1933.)

EXAMPLE:

In the preceding example, if B borrowed the ring of B cannot refuse to return the ring on the ground of compensation because no compensation can take place when one of the debts arises from a commodatum.

The purpose of the law is to prevent a breach of trust and confidence on the part of the borrower (or depositary in a *depositum*).

A, however, can assert compensation of the value of the ring against the credit of B.

(3) *Where one of the debts arises from a claim for support due by gratuitous title. — "Support* comprises everything that is indispensable for sustenance, dwelling, clothing, medical attendance, education and transportation, in keeping with the financial capacity of the family.[5] x x x." (Art. 194, Family Code [Exec. Order No. 194].)

[5]Art. 195. Subject to the provisions of the succeeding articles, the following are obliged to support each other to the whole extent set forth in the preceding article:

(1) The spouses;

(2) Legitimate ascendants and descendants;

(3) Parents and their legitimate children and the legitimate and illegitimate children of the latter;

(4) Parents and their illegitimate children and the legitimate and illegitimate children of the latter; and

(5) Legitimate brothers and sisters, whether of the full or half-blood. (Family Code)

EXAMPLES:

(1) B is the father of A, a minor, who under the law is entitled to be supported by B. Now A owes B P1,000.00.

B cannot compensate his obligation to support A by what A owes him because the right to receive support cannot be compensated with what the recipient (A) owes the obligor (B). The right to receive support cannot be compensated because it is essential to the life of the recipient. (Report of the Code Commission, p. 90.)

However, if B failed to support A say, for three months, the support in arrears may be compensated with the debt of A.[6] The reason is that A no longer needs the support in arrears as he was able to exist even without the support of B.

(2) "A donates to B an allowance of P1,000.00 a month for five (5) years for the latter's support. However, previous to the donation, B already owed A P10,000.00 which was due and unpaid.

In this case, A cannot say to B 'Inasmuch as you owe me P10,000.00, I will not pay your allowance for ten months.' " (see Memorandum of the Code Commission, March 8, 1951, pp. 13-14.)

(4) *Where one of the debts consists in civil liability arising from a penal offense.* — "If one of the debts consists in civil liability arising from a criminal offense, compensation would be improper and inadvisable because the satisfaction of such obligation is imperative." (Report of the Code Commission, p. 134; see Metropolitan Bank & Trust Company vs. Tonda, 338 SCRA 254 [2000].)

EXAMPLE:

A owes B P1,000.00. B stole the ring of A worth P1,000.00. Here, compensation by B is not proper.

But A, the offended party, can claim the right of compensation. The prohibition in Article 1288 pertains only to the accused but not to the victim of the crime.

**ART. 1289. If a person should have against him several debts which are susceptible of compensation, the rules on the**

[6]Article 301 of the Civil Code mentioned in Article 1287 has been deleted in the Family Code. It provides: "The right to receive support cannot be renounced; nor can it be transmitted to a third person. Neither can it be compensated with what the recipient owes the obligor.

However, support in arrears may be compensated and renounced, and the right to demand the same may be transmitted by onerous or gratuitous title."

**application of payments shall apply to the order of the compensation. (1201)**

### Rules on application of payments applicable to order of compensation.

Compensation is similar to payment. If a debtor has various debts which are susceptible of compensation, he must inform the creditor which of them shall be the object of compensation. In case he fails to do so, then the compensation shall be applied to the most onerous obligation. (Arts. 1252, 1254.)

EXAMPLE:

A is indebted to B in the amount of:

(1) P1,000.00 without interest due today;

(2) P1,000.00 with interest of 12% due to also today; and

(3) P1,000.00 with interest of 10% due yesterday.

B owes A P1,000.00 due today.

For purposes of the application of payment, A is the debtor. He must specify to B which of the three debts should be compensated. If he fails to inform B, then the latter should apply the compensation to the second obligation of A, namely, the obligation bearing the 12% interest because it is the most onerous obligation.

**ART. 1290. When all the requisites mentioned in Article 1279 are present, compensation takes effect by operation of law, and extinguishes both debts to the concurrent amount, even though the creditors and debtors are not aware of the compensation. (1202a)**

### Consent of parties not required in legal compensation.

(1) *Compensation occurs automatically by mere operation of law.* — From the moment all the requisites mentioned in Article 1279 concur, legal compensation takes place automatically even in the absence of agreement between the parties and even against their will, and extinguishes reciprocally both debts as soon as they exist simultaneously, to the amount of their respective sums. It takes place *ipso jure* from the day all the necessary requisites concur, without need of any conscious intent on the part of the parties and even without

their knowledge, at the time of the co-existence of such cross debts. (Yap Unki vs. Chua Jamco, 14 Phil. 602 [1909]; Republic vs. Court of Appeals, 65 SCRA 186 [1975]; Luengo & Martinez vs. Herrero, 17 Phil. 29 [1910].)

The passage of a subsequent law will not forestall legal compensation that had taken place before its effectivity. (National Sugar Trading vs. Phil. National Bank, 396 SCRA 528 [2003].) In fact, it takes place even against the will of the interested parties. (Bank of the Phil. Islands vs. Court of Appeals, 255 SCRA 571 [1996].)

(2) *Full legal capacity of parties not required.* — As it takes place by mere operation of law, and without any act of the parties, it is not required that the parties have full legal capacity (see Art. 37.) to give or to receive, as the case may be. On the other hand, in order that there may be a valid payment, the parties must have the free disposal of the thing due and capacity to alienate it (see Art. 1239.) and to receive payment (see Arts. 1240-1241.), as the case may be.

**Compensation, a matter of defense.**

Although compensation is produced by operation of law, it is usually necessary to set it up a defense in an action demanding performance. Once proved, its effects retroact or relate back to the very day on which all the requisites mentioned by law concurred or are fulfilled. (see Bank of the Phil. Islands vs. Court of Appeals, *supra*.)

In a case, X bank intercepted funds being coursed through it, for transmittal to another bank, and eventually to be deposited to the account of an individual, Y, who happens to owe some amount of money to X. The Court of Appeals ordered X to return the intercepted amount to Y, who, in turn, was found by the court to be indebted to X. X claims legal compensation. *Held:* X's petition is a "a clever ploy to use this Court (Supreme Court) to validate or legalize an improper act. x x x [X] could have easily disposed of this controversy in ten minutes fast, by means of an exchange of checks with [Y] for the same amount. x x x Instead, this plainly unmeritorious case had to clog our docket and take up the valuable time of this Court." (Phil. National Bank vs. Court of Appeals, 259 SCRA 174 [1996].)

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## SECTION 6. — *Novation*

**ART. 1291. Obligations may be modified by:**

**(1) Changing their object or principal conditions;**

**(2) Substituting the person of the debtor;**

**(3) Subrogating a third person in the rights of the creditor.**
**(1203)**

### Meaning of novation.

*Novation* is the total or partial extinction of an obligation through the creation of a new one which substitutes it.

It is the substitution or change of an obligation by another, which extinguishes or modifies the first, either by changing its object or principal conditions, by or substituting another in place of the debtor, or by subrogating a third person in the rights of the creditor.

### Dual function or purpose of novation.

Novation is a contract containing two stipulations: one to extinguish or modify an existing obligation, and the other to substitute a new one in its place. Unlike other modes of extinction of obligation, novation is a juridical act with a dual function. (Ajax Marketing & Dev. Corp. vs. Court of Appeals, 248 SCRA 222 [1995].) It does not operate as an absolute extinction in the sense that it ends with the extinguishment of an obligation but only as a relative extinction because it creates a new one in place of the old which is thus only "modified." (Art. 1291.)

(1) The novation is extinctive when an old obligation is terminated by the creation of a new obligation that takes the place of the former because of the total incompatibility between the two obligations. An extinctive novation would thus have the twin effects of first, extinguishing an existing obligation and second, creating a new one in its stead. It does not necessarily imply that the new agreement should be complete in itself. Certain terms and conditions may be carried, expressly or by implication, over to the new obligation. (Ligutan vs. Court of Appeals, 376 SCRA 560 [2002].)

(2) Where the change is not extinctive but is merely modificatory, *i.e.*, incidental to the main obligation (*e.g.*, change in interest rates or an extension of time to pay), the new agreement will not have the effect of extinguishing the first but would merely supplement it or supplant some but not all of its provisions. In other words, the old obligation subsists to the extent it remains compatible with the amendatory agreement. (Fabrigas vs. San Francisco del Monte, Inc., 476 SCRA 247 [2006]; see Iloilo Traders Finance, Inc. vs. Heirs of Oscar Soriano, Jr., 404 SCRA 67 [2003]; California Bus Lines, Inc. vs. State Investment House, Inc., 418 SCRA 297 [2003]; Republic Glass Corporation vs. Qua, 435 SCRA 480 [2004].)

Whether the effect is extinctive or merely modificatory, is dependent on the nature of the change and the intention of the parties. In either case, novation is made as provided in Article 1291.

**Kinds of novation.**

They are:

(1) *According to origin:*

(a) *Legal.* — that which takes place by operation of law (Arts. 1300, 1302; see Art. 1224.); or

(b) *Conventional.* — that which takes place by agreement of the parties. (Arts. 1300, 1301.)

(2) *According to how it is constituted:*

(a) *Express.* — when it is so declared in unequivocal terms (Art. 1292.); or

(b) *Implied.* — when the old and the new obligations are essentially incompatible with each other. *(Ibid.)*

(3) *According to extent or effect:*

(a) *Total or extinctive.* — when the old obligation is completely extinguished; or

(b) *Partial or modificatory.* — when the old obligation is merely modified, *i.e.,* the change is merely incidental to the main obligation.

(4) *According to the subject:*

(a) *Real or objective.* — when the object (or cause) or principal conditions of the obligation are changed (Art. 1291[1].);

(b) *Personal or subjective.* — when the person of the debtor is substituted and/or when a third person is subrogated in the rights of the creditor (*Ibid*., [2, 3].); or

(c) *Mixed.* — when the object or principal condition of the obligation *and* the debtor or the creditor or both the parties, are changed. It is a combination of real and personal novations. *(Ibid.)*

ILLUSTRATIVE CASES:

1. *Authorized capital stock of a corporation is increased without knowledge and consent of subscriber.*

*Facts:* S subscribed 100 shares of stock, at par value, in a company whose authorized capital stock was P250,000.00. At the time of the subscription, and without his knowledge and consent, the company increased the capital stock to P500,000.00.

*Issue:* Can S be compelled to pay for said shares?

*Held:* No. Because the increase constitutes a novation by changing the principal conditions, he is not bound by the contract thus novated and is relieved of the obligation contracted by him in the original contract, which became extinguished as a consequence of said novation; even if he made some partial payments, not having been informed of said increase at the time of having made them. *(National Exchange Co. vs. Ramos, 51 Phil. 310 [1927].)*

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2. *Acceptance of payment is made after filing of criminal information for estafa.*

*Facts:* A (agent) received from P (principal) two (2) diamond rings to be sold by A on commission. For failing to return the rings or their cash value, P sued A for estafa. During the pendency of the case, A executed a deed wherein she promised to pay the value of the rings in installments.

A made one payment which P accepted, but the balance was never paid.

*Issue:* Did the acceptance by P of the partial payment novate the original relation between the parties so as to obliterate the criminal liability of A?

*Held:* No. The novation may perhaps apply prior to the filling of the criminal information in court, because up to that time the original trust relation may be converted by the parties into an ordinary creditor-debtor situation, thereby placing the complainant in estoppel to insist on the original trust.

After the justice authorities have taken cognizance of the crime and instituted action in court, the offended party may no longer divest the prosecution of its power to exact the criminal responsibility, as distinguished from the civil. The crime being an offense against the state, only the latter can renounce it. *(People vs. Nery, 10 SCRA 244 [1964].)*

**ART. 1292. In order that an obligation may be extinguished by another which substitutes the same, it is imperative that it be so declared in unequivocal terms, or that the old and the new obligations be on every point incompatible with each other. (1204)**

### Requisites of novation.

In novation, there are four (4) essential requisites, namely:

(1) The existence of a previous valid obligation;

(2) The intention or agreement and capacity of the parties to extinguish or modify the obligation;

(3) The extinguishment or modification of the obligation; and

(4) The creation or birth of a valid new obligation. (see Tiu Siuco vs. Habana, 45 Phil. 707 [1924].)

There can be no novation unless two distinct and successive binding contracts take place, between the same parties with the second designed to replace the preceding convention. Modifications introduced before a bargain becomes obligatory can in no sense constitute novation in law. (see Montelibano vs. Bacolod Murcia Milling, Co., Inc., 5 SCRA 36 [1962].) A loan application, before bank approval, cannot be subsequently novated because the first requisite, a pre-existing obligation, is lacking. (Azolla Farms vs. Court of Appeals, 442 SCRA 133 [2004].)

Where the parties involved are corporations, it must first be proved that the second contract was executed by persons possessing the proper authority to bind their respective principals. (Garcia, Jr. vs. Court of Appeals, 191 SCRA 493 [1990].)

### Novation of judgment.

A final judgment of a court that had been executed but not yet fully satisfied, may be novated by compromise. (Gatchalian vs. Arlegui, 75 SCRA 234 [1977].) In such case, the judgment cannot subsequently be

executed because the agreement supersedes the judgment. (Dormitorio vs. Fernandez, 72 SCRA 388 [1976].)

The novation of a contract or judgment may be subject to a suspensive condition. (see Integrated Construction Services, Inc. vs. Relova, 146 SCRA 360 [1986].)

**Novation with respect to criminal liability.**

Novation is not a mode of extinguishing criminal liability. It may prevent the rise of criminal liability as long as it occurs prior to the filing of the criminal information in court. In other words, novation does not extinguish criminal liability but may only prevent its rise.

In a case, a new agreement was reached by the parties to pay in cash the value of goods delivered, for which a check was issued and subsequently dishonored. The supposed agreement never took effect as petitioner never complied with his undertaking. It was held that the novation theory does not apply where the offer to pay by the debtor, and accepted by the creditor, turns out to be merely an empty promise. In this case, the empty promise only delayed the filing of a use for violation of B.P. Blg. 22 against petitioner. (Diongzon vs. Court of Appeals, 321 SCRA 477 [1999].)

**Novation not presumed.**

While as a general rule, no form of words or writing is necessary to give effect to a novation (Garcia, Jr. vs. Court of Appeals, *supra.*), it must be clearly and unmistakably established by express agreement or by the acts of the parties, as novation is never presumed. (see Broadway Centrum Condominium Corp. vs. Tropical Hut Food Market, Inc., 224 SCRA 302 [1993]; see Phil. Savings Bank vs. Mañalac, Jr., 457 SCRA 203 [2005].) Even if novation were sufficiently shown, the presumptive rule (Art. 1299.) is that conditions attached to the old obligation also attach to the new obligation. (Pacific Mills, Inc. vs. Court of Appeals, 206 SCRA 317 [1992].)

**Ways of effecting conventional novation.**

There are only two (2) ways which indicate the presence of novation and thereby produce the effect of extinguishing an obligation by another which substitutes the same. (NYCO Sales Corp. vs. BA Finance Corp., 200 SCRA 637 [1991].)

*First*, by the express agreement of the parties or acts of equal or equivalent import (Aboitiz vs. De Silva, 45 Phil. 883 [1923].), or *second*, by the irreconcilable incompatibility of the two obligations with each other in every material respect. (see Zapanta vs. De Rotaeche, 21 Phil. 154 [1912]; Rios and Reyes vs. Jacinto, Palma y Hermanos, 49 Phil. 7 [1926]; Inchausti & Co. vs. Yulo, 34 Phil. 778 [1916]; Joe's Radio & Electrical Supply vs. Alto Electronics Corp., 104 Phil. 333 [1958]; Dungo vs. Lopena, 6 SCRA 1007 [1962]; Magdalena Estates, Inc. vs. Rodriguez, 18 SCRA 967 [1966]; National Power Corp. vs. Dayrit, 125 SCRA 849 [1983]; Quinto vs. People, 305 SCRA 708 [1999]; Gammon Phils., Inc. vs. Metro Rail Transit Dev. Corp., 481 SCRA 209 [2006]; Valenzuela vs. Kalayaan Dev. & Industrial Corp., 590 SCRA 380 [2009].) The second way can take place even in the absence of an express agreement.

Thus, to effect an objective novation, it is imperative that the new obligation expressly declares that the old obligation is thereby extinguished, or that the new obligation be on every point incompatible with the new one. In the same vein, to effect a subjective novation by a change in the person of the debtor, it is necessary that the old debtor be released expressly from the obligation and the third person or new debtor assumes his place in the relation. There is no novation without such release as the third person who assumed the debtor's obligation becomes merely a co-debtor or surety. (Ajax Marketing & Dev't. Corp. vs. Court of Appeals, 248 SCRA 222 [1995].)

Since novation is effected only when a new contract has extinguished an earlier contract between the same parties, it necessarily follows that there could be no novation if the parties in the new contract are not the same parties in the old contract. (Slim vs. M.B. Financial Corporation, 508 SCRA 556 [2006].)

ILLUSTRATIVE CASES:

1. *The signatures of two debtors to novation were not obtained by creditor and third debtor.*

*Facts:* By agreement of A and D, the separate debts of the brothers A, B, and C were consolidated in a new promissory note executed and signed by A and D, A binding himself to obtain the signatures of B and C to the note, but this was never done.

In an action instituted by D against A, B, and C, B and C alleged as a defense that as neither A nor D exercised proper diligence in securing their (B's and C's) signatures to the new note, there was tacit consent to permit the obligation to stand as a debt of A alone.

*Issue:* Did the agreement between A and D novate the original obligations of A, B, and C in favor of D?

*Held:* No. The subsequent silence on the part of A and D with respect to the securing of the signatures was of no significance and did not have the effect of extinguishing the old obligations by novation. To give their inaction this effect would mean that D had accepted less security for his loans that he originally had, and that A assumed liabilities which he was under no obligation to assume and for which there was no valid consideration.

Novation is never presumed. In the absence of satisfactory evidence to the contrary, the presumption is that the original obligations have not been extinguished by D taking the promissory note. *(Martinez vs. Cavives, 25 Phil. 581 [1913].)*

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2. *A verbal lease agreement was entered into by the parties subsequent to a written contract/promise to sell.*

*Facts:* Through A, attorney-in-fact, S entered into a written contract/promise to sell three (3) haciendas to B, S a close friend and relative. S claims that the written agreement was novated by a verbal lease agreement between them.

It appears that B did not take any steps to assess his claim over the property either by demanding during the lifetime of S the execution of a deed of sale or causing notice of his adverse claim to be annotated on the certificates of titles even after portions of the property were sold or mortgaged by S with the knowledge of B.

*Issue:* Was the novation satisfactorily proved although the second agreement was merely verbal?

*Held:* Yes. "The novation was clearly and convincingly proven not only by the testimony of A but likewise by the acts and conduct of the parties subsequent to the execution of the contract/promise to sell." It was natural for B to have demanded that the first agreement be in writing to erase any doubt of its binding effect upon S, it having been signed by an agent.

Being close friends and relatives, it could be safely assumed that they did not find it necessary to reduce the second agreement into writing. *(Government vs. Court of Appeals, 144 SCRA 222 [1986].)*

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3. *After three lot owners simultaneously entered into a contract of lease, the two of them entered into a new agreement with the lessee.*

*Facts:* H entered into a memorandum of agreement with X, Y and Z

stipulating that H would lease from them three (3) adjacent commercial lots covered by transfer certificates of titles all in other names. Pursuant to said memorandum of agreement, the parties inked a contract of lease of the said lots for a period of 15 years renewable upon agreement of the parties. Subject contract was to enable H, lessee, to construct a building on the lots. It further provided for other stipulations.

It is H's assertion that the lease contract was novated by X and Y who entered into an agreement with her.

*Issue:* Did the acts of X and Y in entering into the new agreement with H novate the original contract of lease?

*Held:* No. (1) *Lease contract an indivisible one.* — "It bears stressing that the lease contract they had entered into is not a simple one. It is unique in that while there is only one lessee, Huibonhoa [H] and the contract refers to a "LESSOR," there are actually three lessors with separate certificates of title over the three lots on which Huibonhoa constructed the 4-storey building. As Huibonhoa herself ironically asserts, the lease contract is an "indivisible" one because the lessors' interests "cannot be separated even if they owned the lands separately under different certificates of title."

Hence, the acts of Rufina G. Lim and Severino Gojocco [X and Y] in entering into the new agreement with Huibonhoa could have affected only their individual rights as lessors because no new agreement was forged between Huibonhoa and all the lessors, including Z."

(2) *Simultaneous act of all lessors required for novation.* — "Consequently, because the three lot owners simultaneously entered into the lease contract with Huibonhoa, novation of the contract could only be effected by their simultaneously act of abrogating the original contract and at the same time forging a new one in writing. Although as a rule no form of words or writing is necessary to give effect to a novation, a written agreement signed by all the parties to the lease contract is required in this case.

Ordinary diligence on the part of the parties demanded that they execute a written agreement if indeed they wanted to enter into a new one because of the 15-year life span of the lease affecting real property and the fact that third persons would be affected thereby on account of the express agreement allowing the lessee to lease the building to third parties."

(3) *Novation never presumed.* — "Under the law, novation is never presumed. The parties to a contract must expressly agree that they are abrogating their old contract in favor of a new one. Accordingly, it was held that no novation of a contract had occurred when the new agreement entered into between the parties was intended 'to give life' to the old one.

'Giving life' to the contract was the very purpose for which Rufina G. Lim signed the agreement on January 31, 1986 with Huibonhoa. It was intended to graft into the lease contract provisions that would facilitate fulfillment of Huibonhoa's obligation therein.

That the new agreement was meant to strengthen the enforceability of the lease is further evidenced by the fact, although its stipulations as to the period of the lease and as to the amount of rental were altered, the agreement with Rufina G. Lim does not even hint that the lease itself would be abrogated. As such, even Huibonhoa's agreement with Rufina G. Lim cannot be considered a novation of the original lease contract. Where the parties to the new obligation expressly recognize the continuing existence and validity of the old one, where, in other words, the parties expressly negated the lapsing of the old obligation, there can be no novation." *(Huibonhoa vs. Court of Appeals, 320 SCRA 635 [1999].)*

**Burden of showing novation.**

The burden of establishing a novation is on the party who asserts its existence. (Martinez vs. Cavives, 25 Phil. 581 [1913].) The necessity to prove the same by clear and convincing evidence is accentuated where the obligation of the debtor has already matured. (Guerrero vs. Court of Appeals, 29 SCRA 791 [1969].)

**Incompatibility between two obligations or contracts.**

(1) *Incompatibility in any of the essential elements of obligation.* — When not expressed, incompatibility is required so as to ensure that the parties have indeed intended such novation despite their failure to express it in categorical terms. The incompatibility should take place in any of the essential elements of the obligation, *i.e.:*

(a) the juridical relation or tie, such as from a mere *commodatum* to lease of things, or from *negotorium gestio* to agency, or from a mortgage to antichresis, or from a sale to one of loan; or

(b) the object or principal conditions such as a change of the nature of the prestation; or

(c) the subjects, such as the substitution of a debtor or the subrogation of the creditor. (Ligutan vs. Court of Appeals, 376 SCRA 560 [2002].)

In other words, there must be an essential change (Young vs. Court of Appeals, 196 SCRA 795 [1991]; Pilipinas Bank vs. Ong, 387 SCRA 37

[2002].); otherwise, the change is merely modificatory in nature and insufficient to extinguish the original obligation. The fact that two agreements are co-terminous with each other does not imply that a new obligation has arisen. (Gaw vs. Intermediate Appellate Court, 220 SCRA 405 [1993].)

(2) *Test of incompatibility.* — The test is whether they can stand together without conflict, each one having its own independent existence. If they cannot, they are incompatible, and the subsequent obligation novates the first. Upon such novation, the former obligation loses all its force and effect and only the new obligation can be the basis of an action. (De Borja vs. Mariano, 66 Phil. 393 [1938]; Canada, Jr. vs. Court of Appeals, 181 SCRA 762 [1990]; Young vs. Court of Appeals, *supra;* Fortune Motors [Phils.] Corp. vs. Court of Appeals, 267 SCRA 653 [1997]; Fabrigas vs. San Francisco del Monte, Inc., 476 SCRA 247 [2006]; Kwong vs. Gargantos, 507 SCRA 540 [2006].)

Corollarily, changes that breed incompatibility must be essential in nature and not merely accidental. The incompatibility must take place in any of the essential elements of the obligation, such as its object, cause, or principal conditions; otherwise, the change is merely modificatory *(infra.)* and insufficient to extinguish the original obligation. (Pilipinas Bank vs. Ong, *supra*.)

(a) A compromise agreement which merely clarified the total sum owed by the would-be buyer to the would-be seller with the view that the former would find it easier to comply with his obligation under the contract to sell does not novate said contract to sell. In fine, the compromise agreement[1] can stand together with the contract to sell. (Rillo vs. Court of Appeals, 274 SCRA 461 [1997].)

(b) Similarly, if the change consists only in the time or place of payment, or in the mode or manner of payment, or rates of interest, without really effecting a substitution of debtor, or adds other obligations not incompatible with the old one, or where the new

[1]A compromise agreement may be entered into without novating or supplanting existing contracts. The whole essence of a compromise is that in making reciprocal concessions the parties avoid a litigation or put an end to one already commenced. The parties may agree to a settlement or arrangement in order to avoid a litigious situation without entering into a new contract. The compromise agreement may co-exist with the original contract. (Riser Airconditioning Services Corp. vs. Confield Construction Dev. Corp., 438 SCRA 471 [2004].)

contract merely supplements the old one, the change is merely modification in nature and insufficient to extinguish the original obligation. (Quinto vs. People, 305 SCRA 708 [1999]; Iloilo Traders Finance, Inc. vs. Heirs of Oscar Soriano, Jr., 404 SCRA 67 [2003]; California Bus Lines, Inc. vs. State Investment House, Inc., 418 SCRA 297 [2005].) The term "principal condition" in Article 1291 includes a change in the "period" to comply with the obligation. Such a change, however, would only be a partial novation since the period merely affects the performance, not the creation of the obligation. (Ong vs. Bogñalbal, 501 SCRA 490 [2006].)

(c) An agreement subsequently executed between a seller and a buyer that provides for a different schedule and manner of payment, to restructure the mode of payments by the buyer so that it could settle its outstanding obligation in spite of its delinquency in payment is not tantamount to novation. (California Bus Lines, Inc. vs. State Investment House, Inc., *supra*.)

(d) A deed of cession of the right of repurchase of a piece of land does not supersede a contract of lease over the same property where there is no clear agreement to create new contract in place of the existing one. (Espina vs. Court of Appeals, 334 SCRA 186 [2000], citing Tolentino, Civil Code of the Phils., Vol. IV, 1993 reprinting, pp. 383-384.)

(e) Novation is merely modificatory where the change brought about by any subsequent agreement is merely incidental to the main obligation. Thus, where parties to a case for the collection of a loan increased the indebtedness due to accruing interest from P290,691 to P431,200; where the compromise agreement extended the period of payment and provided for new terms of payment; and where it provided for a waiver of claims, counterclaims, attorney's fees or damages that the debtors might have against their creditors, but the settlement neither cancelled, nor materially altered the usual clauses in the real estate mortgages, *e.g.*, the foreclosure of the mortgaged property in case of default, it was held that the original obligation of the debtors had been impliedly modified. (Iloilo Traders Finance, Inc. vs. Heirs of Oscar Soriano, Jr., *supra*.)

(f) In a case, an examination of the Deed of Absolute Sale and the Promissory Note, as well as the surrounding circumstances,

shows that the deed was intended to novate and replace the Deed of Conditional Sale, it appearing that the two deeds cannot co-exist being of different nature and as they provide for separate and distinct obligations. (Kwong vs. Gargantos, *supra*.)

(g) What actually takes place in *dacion en pago* (see Art. 1245.) is an objective novation of the obligation where the thing offered as an accepted equivalent of the performance of an obligation is considered as the object of the contract of sale while the debt is considered as the purchase price. (Aquintey vs. Tibong, 511 SCRA 414 [2006].)

ILLUSTRATIVE CASES:

1. *Contract simply gave the judgment debtor another method and more time for the satisfaction of said judgment.*

*Facts:* A secured a judgment against B. Later, a contract was entered between A and B by the terms of which the said judgment was to be extinguished by monetary payments, with the provision that, in case of default by B, A "shall be at liberty to enter suit against him." B defaulted, and A secured an execution upon said judgment for the unpaid balance.

B brought action against A for damages on the ground that the judgment was merged in the contract and the levy and sale of B's property under execution was, therefore, null and void.

*Issue:* Did the contract in question extinguish by novation the obligation in the said judgment?

*Held:* No. In order to extinguish one obligation by the creation of another, the extinguishment must be clear. The new contract was not a new and independent obligation expressly extinguishing the judgment; neither were its terms incompatible with the obligation of the judgment. On the contrary, the contract expressly ratified said obligations and contained provisions for satisfying them. The agreement simply gave B another method and more time for the satisfaction of said judgment. It did not extinguish the obligations contained in said judgment until the terms of said contract had been fully complied with.

Had B continued to comply with the conditions of said contract, he might have successfully invoked its provisions against the issuance of an execution against said judgment. The judgment was not satisfied and the obligations existing thereunder still subsisted. (*Zapanta vs. De Rotaeche, 21 Phil. 154 [1912];* see Millar vs. Court of Appeals, 38 SCRA 642 [1971].)

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2. *Creditor agreed to substitution of debtor but subject to a condition.*

*Facts:* A was a creditor of partnership X. Subsequently, X sold all its assets to B who assumed all its liabilities. B in turn sold the assets to C who also assumed the liabilities of X including the credit in favor of A. To this assignment, A gave his approval on condition that C furnished two bondsmen who would guarantee his fulfillment of the undertaking. C failed to comply with the condition.

A brought action against B demanding payment. B claimed novation due to the substitution of debtor.

*Issue:* Is the contention of B tenable?

*Held:* No. Since the condition was not fulfilled, B was not substituted by C. *(Vaca vs. Kosca, 26 Phil. 388 [1913].)*

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3. *Chattel mortgage was accepted by the creditor merely as an additional security.*

*Facts:* A chattel mortgage was accepted by a bank for goods already transferred to it by warehouse receipts. The chattel mortgage omitted any mention of the receipts. There is no evidence whatever to show that a novation was intended.

*Issue:* Did the mere acceptance operate to extinguish by novation the prior transfer?

*Held:* No. Novations are never presumed and must be clearly proven. "The chattel mortgage was evidently taken as additional security for the funds advanced by the bank and the transaction was probably brought about through a misconception of the relative values of warehouse receipts and chattel mortgages. As the warehouse receipts transferred the title to the goods to the bank, the chattel mortgage was both unnecessary and inefficacious and may be properly disregarded."

Consequently, the bank may still insist on the rights acquired by it under the warehouse receipt as governed by the Warehouse Receipts Act. (*Bank of the Phil. Islands vs. Herridge, 47 Phil. 57 [1924];* see Leonor vs. Sycip, 1 SCRA 1215 [1961].)

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4. *Terms of the new obligation are different from the judgment claimed to have been novated.*

*Facts:* A obtained a judgment sentencing B to pay him P1,500.00 with interest and costs. Subsequently, they entered into a contract under which the obligation under the judgment was reduced to P1,200.00, payable in

installments, to secure the payment of which, B mortgaged his camarin to A, B binding himself to pay 10% of the unpaid balance as attorney's fees plus costs of the action to be brought by A in case of default.

*Issue:* Was the obligation of B under the judgment novated by the contract?

*Held:* Yes. Although the contract did not expressly extinguish the old obligation, the same was impliedly novated by reason of incompatibility resulting from the fact that whereas the judgment was for P1,500.00 payable at one time, did not provide for attorney's fees, and was not secured, the new obligation is for P1,200.00 payable in installments, stipulates for attorney's fees, and is secured by a mortgage. *(Fua Cam Lu vs. Yap Fauco, 74 Phil. 287 [1942].)*

**Effect of modifications of original obligation.**

(1) *Slight modifications and variations.* — When made with the consent of the parties, they do not abrogate the entire contract and the rights and obligations of the parties thereto, but the original contract continues in force except as the altered terms and conditions of the obligation are considered to be the essence of the obligation itself. This is especially true where the original contract expressly provides that such modifications and alterations may be made. (see 9 C.J. 721.)

Under Article 1291(1), the change must involve the "principal" conditions of the obligation.

(a) Thus, it has been held that there was no novation of the original contract of loan where the debtor, to avoid an immediate demand for the payment of the principal, *promised to pay an extra rate of interest* which he was under no obligation to pay, as such promise was a mere contractual agreement, separate and distinct from the original contract which remained unchanged. (Bank of P.I. vs. Gooch and Redfern, 46 Phil. 514 [1924].)

(b) Also, a *mere extension of the term (period)* for payment or performance is not a novation; while the extension covers some of the area originally agreed upon, this change does not alter the essence of the contract (see Board of Liquidators vs. Floro, 110 Phil. 482 [1960]; see however, Art. 2079.); nor does the *addition of a new obligation* (*e.g.*, guaranty) not inconsistent with the old one constitute novation. (Tible vs. Aquino, 65 SCRA 207 [1975]; Magdalena Estates, Inc. vs. Rodriguez, 18 SCRA 967 [1966].)

(c) Neither is there a novation, where the *surety* subsequently made an agreement with the creditor *to be bound also as principal* and no longer as surety on the same obligation, and, therefore, the principal debtor is not released from said obligation. (Santos vs. Reyes, 10 Phil. 123 [1908].)

(d) The mere *reduction of the amount due* in no sense constitutes a sufficient *indicium* of incompatibility, especially in the light of the explanation by the creditor that the reduced indebtedness was the result of partial payments. (Millar vs. Court of Appeals, 38 SCRA 642 [1971].)

(e) The *acceptance of a partial payment* by a creditor before the maturity of the obligation is not a novation of the contract but a waiver of the period agreed upon during which payment should not be made. It is a relinquishment of his right to refuse any payment before the expiration of the term. (Lopez vs. Ochoa, 103 Phil. 950 [1958].)

(f) The *consolidation of three (3) loan agreements* all secured by the same real estate executed by a third person, which loans were granted separately to three (3) entities, into a single loan through the execution of a promissory note did not effect a novation that would release the mortgaged property from liability where there is nothing in the records to show that such was the unequivocal intent of the parties. (Ajax Marketing & Dev't. Corp. vs. Court of Appeals, 248 SCRA 222 [1995].)

(g) There is no novation where the second contract, a real estate mortgage, indicates that the same was executed as *new additional security* to the chattel mortgage previously entered into by the parties who agreed that the chattel mortgage "shall remain in full force and that not be impaired by this (real estate) mortgage.'' (People's Bank and Trust Co. vs. Syvel's, Inc., 164 SCRA 247 [1988]; see Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999].)

(h) There is no novation where the *obligation to pay a sum of money remained*, and the assignment of rights over the mortgaged properties merely served as security for the loans covered by the promissory notes. Thus, where the deed of assignment of leasehold rights merely provided for the appointment by the mortgagor (grantee of a fishpond lease agreement from the government) of the mortgagee as attorney-in-fact with authority, among other

things, to sell or otherwise dispose of the said rights in case of default by the mortgagor and to apply the proceeds to the payment of the loan covered by promissory notes, the said assignment did not novate the notes, as it was only an accessory to the notes; it merely complemented or supplemented the notes; hence, both could stand together. (Development Bank of the Philippines vs. Court of Appeals, 284 SCRA 14 [1998].)

(i) When the *changes refer to secondary agreements*, there is no novation; such changes will produce modifications of incidental facts, but will not extinguish the original obligation. (Young vs. Court of Appeals, 196 SCRA 795 [1991], citing IV Tolentino, Civil Code of the Phils., p. 388 [1985 Ed.].)

(j) An obligation to pay a sum of money is not novated in a new instrument wherein the *old is modified by changing only the terms of payment*, and adding other obligations not incompatible with the old one, or wherein the old contract is merely supplemented by a new one. The mere fact that the creditor receives a guaranty or accepts payments from a third person who has agreed to assume the obligation, when there is no agreement that the first debtor shall be released from responsibility does not constitute novation. (Magdalena Estates, Inc. vs. Rodriguez, 18 SCRA 967 [1966]; Velasquez vs. Court of Appeals, 309 SCRA 539 [1999]; Reyes vs. Court of Appeals, 383 SCRA 471 [2002]; Reyes vs. BPI Family Savings Bank, Inc., 486 SCRA 276 [2006]; Villanueva, Jr. vs. Court of Appeals, 487 SCRA 571 [2006]; Transpacific Battery Corp. vs. Security Bank & Trust Co., 587 SCRA 536 [2009].)

(k) An obligation to pay a sum of money evidenced by three (3) promissory notes for the amount of $50,000 each and uniformly provided for a term of three (3) years, 15% interest *per annum* payable quarterly, and the repayment of the principal loans after three (3) years from their respective dates, is merely modified where *the interest was waived and the principal was payable in monthly installments* of P750, since the obligation to pay the sum of money remains force. (Swagman Hotels and Travel Inc. vs. Court of Appeals, 455 SCRA 175 [2005].)

(2) *Material deviations or changes.* — Where the original contract is deviated from in material respects so that the object or principal condition cannot reasonably be recognized as that originally contracted

for, the original contract should be treated as abandoned. (see 9 C.J. 721; Tiu Suico vs. Habana, 45 Phil. 707 [1924].)

ILLUSTRATIVE CASES:

1. *Changes in the construction of a building were made on the basis of the original contract.*

*Facts:* X and Y entered into a contract, whereby X agreed to construct the house of Y costing P54,000. In the course of the construction, alterations were ordered by Y. After completion, Y paid P54,000 plus P4,000.

X was not satisfied with this payment. He brought an action praying recovery on *quantum meruit* claiming that the original contract was novated.

*Issue:* Is there a novation of the original contract?

*Held:* No. There was no claim or pretense that anything was said by either party about terminating or rescinding the contract. Although numerous changes were made, and there was a material increase in the building, there was no material change in its size or dimensions.

In other words, the original contract was used as a basis for the construction of the building, and any changes or alterations which were made were founded upon the original contract, and were made with the understanding that Y would pay the reasonable value of all such changes and alterations. As there was no novation, X was never released from the original contract. *(Tiu Siuco vs. Habana, supra.)*

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2. *Period stipulated in the first contract is reduced.*

*Facts:* In the first contract, the duration of the right of way which X bound herself to impose upon her estate in favor of Y was 20 years. In the second contract, that period was reduced to 7 crops equivalent to 7 years. The duration of the right of way is one of the principal conditions of both contracts.

*Issue:* Are the two contracts incompatible with each other?

*Held:* Yes. The second contract reduces the period in the first. The terms in the second cannot be added to that in the first as this would make the period 27 instead of 20 years, which is greater than the period stipulated in the first contract. Insofar as the duration of the right of way is concerned, the two contracts are incompatible with each other, and so they cannot subsist at the same time. *(Kabankalan Sugar Co., Inc. vs. Pacheco, 55 Phil. 555 [1930].)*

**ART. 1293. Novation which consists in substituting a new debtor in the place of the original one, may be made even without the knowledge or against the will of the latter, but not without the consent of the creditor. Payment by the new debtor gives him the rights mentioned in Articles 1236 and 1237. (1205a)**

### Kinds of personal novation.

Personal novation may be in the form of:

(1) *Substitution.* — when the person of the debtor is substituted (Art. 1291[2].); or

(2) *Subrogation.* — when a third person is subrogated in the rights of the creditor. *(Ibid.,* [3]; Art. 1300.)

### Kinds of substitution.

Article 1293 speaks of substitution which, in turn, may be:

(1) *Expromision* or that which takes place when a third person of his own initiative and without the knowledge or against the will of the original debtor assumes the latter's obligation with the consent of the creditor. (8 Manresa 436; Arts. 1293-1294.) It logically requires the consent of the third person and the creditor. (De Cortez vs. Venturanza, 79 SCRA 709 [1977].) It is essential that the old debtor be released from his obligation; otherwise, there is no *expromision*; or

(2) *Delegacion* or that which takes place when the creditor accepts a third person to take the place of the debtor at the instance of the latter. The creditor may withhold approval. (*Ibid.;* Art. 1295.) In *delegacion,* all the parties, the old debtor, the new debtor (see Martinez vs. Cavives, 25 Phil. 581 [1913].), and the creditor must agree. (see Pacific Commercial Co. vs. Sotto, 34 Phil. 237 [1915].)

In either of these two modes of substitution, the consent of the creditor is an indispensable requirement. (De Cortez vs. Venturanza, *supra.*)

### Right of new debtor who pays.

(1) In *expromision,* payment by the new debtor gives him the right to beneficial reimbursement under the second paragraph of Article 1236.

(2) If the payment was made with the consent of the original

debtor or on his own initiative *(delegacion)*, the new debtor is entitled to reimbursement and subrogation under Article 1237.

**Acceptance by creditor of payment from a third person.**

It is a common thing in business affairs for a stranger to a contract to assume its obligations, and while this may have the effect of adding to the number of persons liable, it does not necessarily imply the extinguishment of the liability of the first debtor. (Rios and Reyes vs. Jacinto, Palma y Hermanos, 49 Phil. 7 [1926].)

> "In case of subjective novation through a change in the person of debtor, it is not enough that the juridical relation between the original parties is extended to include a third person, as this constitutes only an increase in the number of persons liable to the obligee. It is essential that the old debtor be released from the obligation and the third person takes his place in the relation. If the older debtor is not released, there is no novation; the third person becomes merely a co-debtor surety." (Cochingyan vs. R & B Surety, 151 SCRA 339 [1987].)

Novation is never presumed; thus, the mere fact that the creditor receives a guaranty or accepts payment from a third person who has agreed to assume the obligation, when there is no agreement that the first debtor shall be released from responsibility, does not constitute a novation, and the creditor can still enforce the obligation against the original debtor. (Dungo vs. Lopena, 6 SCRA 100 [1962]; Mercantile Insurance Co., Inc. vs. Court of Appeals, 196 SCRA 197 [1991]; Phil. Savings Bank vs. Mañalac, Jr., 457 SCRA 203 [2005].) This rule applies to a surety bond which is not a new and separate contract but an accessory of the principal obligation. (Magdalena Estates, Inc. vs. Rodriguez, 18 SCRA 967 [1966].)

EXAMPLES:

(1) D (debtor) tells C (creditor) that X will pay D's debt. C agrees. It does not necessarily mean that there is *delegacion* here. But if D tells B that X will pay his debt and he asks C to release him from his obligation, to which C agrees, *delegacion* results.

(2) Suppose, in the same example, it is X who approaches C and tells him that X will pay the debt of D. C agrees. There is no *expromision*

in this case, unless there is an agreement that D shall be released from his obligation to C.

ILLUSTRATIVE CASES:

1. *Contract permits adding to the number of persons liable.*

*Facts:* R (lessor) leased his property to partnership X, with the stipulation in the contract that the provisions of the lease should be obligatory upon and redound to the benefit not only of the lessee (X) but to its assignee. X was succeeded as lessee by partnership Y, and the latter, by partnership Z, and the last to be itself succeeded by W, a corporation.

R, who was informed of these successive changes, accepted the monthly rents from whoever was the possessor. As W was not able to continue paying, R brought action against X to recover the rents in arrears.

*Issue:* Was X discharged by a novation of the original contract whereby the lessee (X) was changed and a new debtor (W) substituted for the original one?

*Held:* No. The transfer of the lease was anticipated in the contract and stipulated for, and R (lessor) had no right to complain as the leased premises passed from one entity to another. The contract does not stipulate that X (original lessee) should be discharged by any such assignment and an agreement to this effect cannot be implied from the forced acquiescence of R in the transfer of the lease.

In this case, the new obligation assumed by the successive entities was not at all incompatible with the continued liability of X. It is a very common thing in business affairs for a stranger to a contract to assume its obligations; and while this may have the effect of adding to the number of persons liable, it by no means necessarily implies the extinguishment of the liability of the first debtor. *(Rios and Reyes vs. Jacinto Palma y Hermanos, 49 Phil. 7 [1926].)*

*Note:* Under Article 1650 of the Civil Code, when in the contract of lease there is no express prohibition, the lessee may sublet the thing leased. The rule is different with respect to assignments of lease. Article 1649 provides that "the lessee cannot assign the lease without the consent of the lessor, unless there is a stipulation to the contrary. The consent of the lessor is necessary if the assignment would involve the transfer not only of rights but also of obligations of the lessee. Such assignment would constitute novation by the substitution of one of the parties, *i.e.*, the lessee. (see Sadhwani vs. Court of Appeals, 281 SCRA 75 [1997].)

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2. *Debtor merely authorized another to pay creditor.*

*Facts:* D obtained a loan in the sum of P3,000.00 from C. D authorized B (bank) to pay his indebtedness to C out of whatever crop loan might be granted to him by B. The crop was granted under certain conditions, one of which, that whatever D owed B in connection with the crop loan granted him for the previous year would be charged against the loan for the current year.

In reality, there were no funds to the credit of D that could be applied to the payment of D's obligation to C. The branch manager of B paid P2,000.00 to C. For the error thus committed, he was reprimanded by his employer. C sued D and B for the balance of P1,000.00.

*Issue:* Is B liable to C for the remainder of D's indebtedness?

*Held:* No. B did not assume the obligation of D to C, neither as co-principal, nor as a surety or guarantor. D simply authorized B to pay the amount D owed C out of the proceeds of the crop loan which B would grant D. The error committed by the branch manager of B cannot be construed as binding his principal to pay the remainder of D's obligation. *(Hodges vs. Rey, 1 SCRA 636 [1961].)*

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3. *Mortgagor sold the mortgaged property to another who made partial payments.*

*Facts:* S sold to B a building, B promising to pay the unpaid balance of the price with interest and mortgaging the property as security. Subsequently, B sold the property to C, the latter agreeing to pay the balance and to respect the mortgage. C made several payments to S.

When neither B nor C made further payment, S brought action for recovery of the remaining balance with interest and the foreclosure of the mortgage.

*Issue:* Is B released from his obligation to S on the ground of substitution of C as the new debtor?

*Held:* No. Novation cannot be presumed. S did not intervene in the contract between B and C and did not expressly give his consent to the substitution. The fact that S did not oppose the sale of the mortgaged property could not prejudice him. The mortgage was merely an encumbrance and, therefore, B had the right to make the sale, which S could not oppose and which at all events, could not affect the mortgage, as the latter follows the property whoever the possessor may be. (Art. 2126.)

The fact that S has received payments from C on account of B's obligation is of no importance, for this is, at most, a payment by a third person which, while it may create a juridical relation between B and C,

cannot affect the relation between S and B except that the obligation thus paid is discharged. *(E.C. McCullough & Co. vs. Velso and Serna, 43 Phil. 1 [1922].)*

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4. *First mortgagee consented to registration of second mortgage on condition of full payment of debtor's outstanding obligation but second mortgagee made partial payment only.*

*Facts:* DBP agreed to guarantee LC's foreign loan subject to the condition that LC should deposit with DBP the proceeds of the loan which should be made available for payments of LC's obligation to local financial institution and to serve as working capital. DBP informed PCIB that the former had guaranteed LC's foreign loan and asked that it be lent the titles covering parcels of land mortgaged to PCIB by LC for DBP to be able to register its mortgage thereon.

PCIB interposed no objection on the condition that it would "be favored immediately with a remittance in full of LC's outstanding obligations, after which it would issue the necessary Deed of Release of Real Estate Mortgage." DBP made a partial payment only of LC's outstanding obligation.

*Issue:* Is PCIB estopped from foreclosing the mortgage on the ground of novation?

*Held:* No. Under the facts, DBP did not substitute LC as debtor to PCIB. PCIB agreed to the registration of DBP's second mortgage and to cancel or release the first mortgage upon receipt in full of the payment of LC's mortgage debt. In substitution, it is not enough that the juridical relation of the parties to the original contract is extended to a third person; it is necessary that the old debtor be released from the obligation and the third person or new debtor takes his place in the new relation.

Without such release, there is no novation, the third person who has assured the obligation of the debtor merely becomes a co-debtor or surety. If there is no agreement as to solidarity, the first and new debtors are considered obligated jointly. *(La Compaña Food Products, Inc. vs. Phil. Commercial and Industrial Bank, 142 SCRA 394 [1986].)*

### Consent of creditor necessary to substitution.

In both the two modes of substitution *(supra.)*, the consent of the creditor is an indispensable requirement. (De Cortez vs. Venturanza, 79 SCRA 709 [1977]; Baysaw vs. Interphil. Promotions, Inc., 148 SCRA 635 [1987].)

(1) *Substitution implies waiver by creditor of his credit.* — Since novation of a contract by substitution of a new debtor extinguishes the personality of the first debtor, it implies on the part of the creditor a waiver of the right he had before the novation. Hence, the creditor's consent is necessary to the substitution of a new debtor. (Testate Estate of Mota vs. Serra, 47 Phil. 464 [1925]; Rodriguez vs. Reyes, 37 SCRA 195 [1971].)

(2) *Substitution may be prejudicial to creditor.* — The requirement is based on simple consideration of justice since the consequence of the substitution may be prejudicial to the creditor and such prejudice may take the form of delay in the fulfillment of the obligation, or contravention of its tenor, or non-performance thereof by the new debtor (see 8 Manresa 436.), by reason of his financial inability or insolvency.

Thus, where X and Y bought from S a land with the unpaid balance of the purchase price secured by a mortgage thereon, in the foreclosure proceedings by S, X cannot avoid liability on the ground that he had transferred his interest in the property to Y. Such transfer cannot affect the relation between X and Y, on the one hand, and S, on the other, since S is not a privy to the agreement between X and Y. (De Cortez vs. Venturanza, *supra.*)

(3) *Creditor has right to refuse payment by third person without interest in obligation.* — It is also consistent with the rule that a creditor cannot be compelled to accept payment or performance by a third person who has no interest in the fulfillment of the obligation. (see Art. 1236, par. 2.) The creditor, however, may accept, if he so wishes, payment from a third party. But mere acceptance of payments for the benefit of a debtor, whose obligation the third party has assumed, in the absence of facts unmistakably showing an intention to make the third party alone liable, does not constitute a novation consisting in the substitution of a new debtor in lieu of the old one. (see Pacific Commercial Co. vs. Sotto, 34 Phil. 237 [1915]; see Dungo vs. Lopena, 6 SCRA 100 [1962].)

Article 1293 does not state that such consent to the change of debtor be express, or given at the time of the substitution. Its evident purpose being to preserve the creditor's full right, it is sufficient that his consent be given at any time and in any form whatever, while the agreement of the debtors subsists. (Asia Banking Corp. vs. Elser, 54 Phil. 994 [1930].) The creditor may impose conditions for the substitution.

(4) *Involuntary novation by substitution of debtor.* — By means of garnishment (see Art. 1243.), which is a species of attachment or execution for reaching any property pertaining to a judgment debtor which may be found owing to such a debtor by a third person, the latter, through service of the writ of garnishment, becomes a virtual party to, or a "forced intervenor" in the case. The court, having acquired jurisdiction over the person of the garnishee, requires him to pay his debt, not to his former creditor, but to the new creditor, who is creditor in the main litigation.

The remedy is merely a case of involuntary novation by the substitution of one creditor for another. (Tayabas vs. Land Co. vs. Sharruf, 41 Phil. 382 [1921]; Perla Compania de Seguros, Inc. vs. Ramolete, 203 SCRA 487 [1991]; see PNB Management and Development Corp. vs. R & R Metal Casting and Fabricating, Inc., 373 SCRA 1 [2002].)

ILLUSTRATIVE CASE:

*Implied consent of creditor to substitution.*

*Facts:* S, being indebted to X Corporation for the value of the shares he had subscribed, sold to B said shares on condition that B would assume S's debt to X Corporation. Before the sale to B, there was an understanding between B and the principal stockholders of X Corporation to the effect that B was to be substituted for S as stockholder in order to increase the capital of the corporation by the contribution of B.

The contract of sale was known to the directors of X Corporation and in a special meeting by virtue of said contract, they elected B president of the corporation and member of the board in place of S.

*Issue:* Did X Corporation consent to the substitution?

*Held:* Yes. The existence of consent need not be expressed; it may be inferred from the acts of the creditor, since volition may as well be expressed by deeds as by words.

The understanding between B and the principal director of X Corporation with respect S's stock in said corporation, and the acts of the board of directors after B had acquired said shares in substituting B for S are clear and unmistakable expression of consent. Therefore, B and not S is under obligation *to* X Corporation for said debt. *(Asia Banking Corp. vs. Elser, supra.)*

**Substitute must be placed in the same position of original debtor.**

In stating that another person must be substituted in lieu of the debtor, Article 1293 means that it is not enough to extend the juridical relation to that other person, but it is necessary to place the latter in the same position occupied by the original debtor who is released from the obligations.

Consequently, the obligation contracted by a third person to answer for the debtor, as in the case of suretyship, in the last analysis, does not work as a true novation, because the third person is not put in the same position as the debtor — the latter continues in his same place and with the same obligation which is guaranteed by the former. (8 Manresa 435-436; Testate Estate of Mota vs. Serra, 47 Phil. 472 [1928].)

**Effect where third person binds himself as principal with debtor.**

Since it is necessary that the third person should become a debtor in the same position as the debtor whom he substitutes, this change and the resulting novation may be with respect to the whole debt, thus releasing, as a general rule, the debtor from his obligation; or he may continue with the character of such debtor and also allow the third person to participate in the obligation.

(1) In the first case, there is complete and perfect novation; in the second, there is a change that does not free the debtor nor authorize the extinguishment of the accessory obligations of the latter. (Estate of Mota vs. Serra, *supra*.) The mere circumstance of the creditor receiving payment from a third party who acquiesced to assume the obligation of the debtor when there is clearly no agreement to release the debtor from her responsibility does not constitute novation. (Reyes vs. Court of Appeals, 264 SCRA 35 [1996].)

(2) It is essential that the old debtor be expressly released from the obligation, and the third person or new debtor take his place in the new relation. Novation is never presumed. If the old debtor is not released, no novation occurs and the third person who has assumed the obligation of the debtor becomes merely a co-debtor or a surety or a co-surety (Cochingyan, Jr. vs. R & B Surety Insurance Co., Inc., 151 SCRA 339 [1987]; Phil. Savings Bank vs. Mañalac, Jr., 457 SCRA 203 [2005].), who binds himself as principal with the debtor.

**ART. 1294. If the substitution is without the knowledge or against the will of the debtor, the new debtor's insolvency or non-fulfillment of the obligation shall not give rise to any liability on the part of the original debtor. (n)**

**ART. 1295. The insolvency of the new debtor, who has been proposed by the original debtor and accepted by the creditor, shall not revive the action of the latter against the original obligor, except when said insolvency was already existing and of public knowledge, or known to the debtor, when he delegated his debt. (1206a)**

### Effect of new debtor's insolvency or non-fulfillment of obligation.

(1) *In expromision.* — Under Article 1294, the new debtor's insolvency or nonfulfillment of the obligation will not revive the action of the creditor against the old debtor whose obligation is extinguished by the assumption of the debt by the new debtor. Remember that in *expromision,* the replacement of the old debtor is not made at his own initiative.

It would seem that even if the substitution is with the knowledge or consent of the original debtor, he is no longer liable. Article 1295 applies if the new debtor "has been proposed by the original debtor and accepted by the creditor."

(2) *In delegacion.* — Article 1295 refers to *delegacion.* It must be noted that the article speaks only of insolvency. If the non-fulfillment of the obligation is due to other causes, the old debtor is not liable.

The general rule is that the old debtor is not liable to the creditor in case of the insolvency of the new debtor.

The exceptions are:

(a) The said insolvency was already existing *and* of public knowledge (although it was not known to the old debtor) at the time of the *delegacion;* or

(b) The insolvency was already existing *and* known to the debtor (although it was not of public knowledge) at the time of the *delegacion.*

The exceptions are intended to prevent fraud on the part of the old debtor.

EXAMPLE:

D owes C P1,000.00. D proposed to C that X would substitute him as debtor. C agreed to the proposal. If, at the time of the *delegacion,* X was already insolvent but his insolvency was neither of public knowledge nor known to D , then D is not liable. Neither is D liable if the insolvency of X took place *after* he delegated his debt.

It is believed that D is also not liable if C had knowledge that X was insolvent at the time the debt was delegated to him.

**ART. 1296. When the principal obligation is extinguished in consequence of a novation, accessory obligations may subsist only insofar as they may benefit third persons who did not give their consent. (1207)**

### Effect of novation on accessory obligations.

The above article follows the general rule that the extinguishment of the principal obligation carries with it that of the accessory obligations. (see Arts. 1230, 1273, 1280.)

It provides, however, an exception in the case of an accessory obligation created in favor of a third person which remains in force unless said third person gives his consent to the novation. (see Art. 1311, par. 2.) This is so because a person should not be prejudiced by the act of another without his consent.

EXAMPLES:

A owes B P2,000.00 with interest at 14%.

B owes C P280.00.

It was agreed among the parties that A would pay the interest of P280.00 to C. In this case, besides the principal obligation of A, there is a stipulation in favor of C, a third person. (see Art. 1311, par. 2.) Later on, A and B executed another contract whereby they agreed that A would deliver to B a television set in payment of the loan.

In spite of the novation, the accessory obligation to pay the interest of P280.00 to C still subsists unless C gives his consent to the novation.

**ART. 1297. If the new obligation is void, the original one shall subsist, unless the parties intended that the former relation should be extinguished in any event. (n)**

**Effect where the new obligation void.**

Article 1297 stresses one of the essential requirements of a novation, to wit: the new obligation must be valid. The general rule is that there is no novation if the new obligation is void and, therefore, the original one shall subsist for the reason that the second obligation being inexistent, it cannot extinguish or modify the first.

To the rule is excepted the case where the parties intended that the old obligation should be extinguished in any event.

**Effect where the new obligation voidable.**

If the new obligation is only voidable, novation can take place. But the moment it is annulled, the novation must be considered as not having taken place, and the original one can be enforced, unless the intention of the parties is otherwise.

**ART. 1298. The novation is void if the original obligation was void, except when annulment may be claimed only by the debtor, or when ratification validates acts which are voidable. (1208a)**

**Effect where the old obligation void or voidable.**

This article has its basis also on the requisites of a valid novation.

A void obligation cannot be novated because there is nothing to novate. However, if the original obligation is only voidable (Art. 1390; *Note:* A voidable obligation is valid until it is annulled in court.) or if the voidable obligation is validated by ratification (see Arts. 1392, 1396.), the novation is valid.

EXAMPLES:

(1) S agreed to deliver prohibited drugs to B. Later on, it was agreed that S would pay B P100,000.00 instead of delivering the drugs.

The novation is void because the original obligation is void.

(2) Suppose S was induced through fraud committed by B to sign a contract whereby S obliged himself to deliver a specific car to B. Subsequently, it was agreed between S and B that S would give B P100,000.00 instead of the car. (see Art. 1293.)

The original obligation of S is voidable. As it has not yet been annulled at the instance of S (see Art. 1397.), the second contract is valid.

(3) In the same example, if S subsequently confirmed his obligation to deliver the car and the right of B thereto, his ratification cleanses the contract from all its defects (Art. 1396.) and makes it valid and, therefore, the novation is also valid.

**ART. 1299. If the original obligation was subject to a suspensive or resolutory condition, the new obligation shall be under the same condition, unless it is otherwise stipulated. (n)**

### Presumption where original obligation subject to a condition.

If the first obligation is subject to a suspensive or resolutory condition, the second obligation is deemed subject to the same condition unless the contrary is stipulated by the parties in their contract.

The reason for the rule contained in Article 1299 is that the efficacy of the new obligation depends upon whether the condition which affects the old obligation is complied with or not. (3 Castan 82.) If the condition is suspensive, and it is not complied with, no obligation arises; and if it is resolutory and it is complied with, the old obligation is extinguished. In either case, one requisite of novation, *i.e.*, a previous valid obligation, would be wanting.

**ART. 1300. Subrogation of a third person in the rights of the creditor is either legal or conventional. The former is not presumed, except in cases expressly mentioned in this Code; the latter must be clearly established in order that it may take effect. (1209a)**

### Meaning of subrogation.

*Subrogation* is the substitution of one person in the place of another with reference to a lawful claim or right, so that he who is substituted succeeds to the right of the other in relation to a debt or claim, including its remedies and securities. It contemplates full substitution such that it places the party subrogated in the shoes of the creditor, and he may use all means which the creditor could employ to enforce payment. (Lorenzo Shipping Corp. vs. Chubb and Sons, Inc., 431 SCRA 266 [2004].)

A subrogee cannot succeed to a right not possessed by the subrogor. *(Ibid.)*

### Kinds of subrogation.

Subrogation may be either:

(1) *Conventional.* — when it takes place by express agreement of the original parties (the debtor and the original creditor) and the third person (the new creditor) (Art. 1301.); or

(2) *Legal.* — when it takes place without agreement but by operation of law. (Art. 1302.)

Conventional subrogation must be clearly established in order that it may take place. (Arts. 1292, 1300.) Legal subrogation is not presumed except in the cases expressly provided by law. (Art. 1302.)

**ART. 1301. Conventional subrogation of a third person requires the consent of the original parties and of the third person. (n)**

### Consent of all parties required in conventional subrogation.

In conventional subrogation, the consent of all the parties is an essential requirement.

(1) *the debtor.* — because he becomes liable under the new obligation to a new creditor.

(2) *the old or original creditor.* — because his right against the debtor is extinguished.

(3) *the new creditor.* — because he may dislike or distrust the debtor.

### Conventional subrogation and assignment of credit distinguished.

Articles 1300 and 1301 do not exclude the power of the creditor (assignor) to transmit his rights without the consent of the debtor to another (assignee) who would then have the right to proceed against the debtor. In this case, there is assignment of credit (see Arts. 1624-1635.) but no subrogation.

*Assignment of credit* has been defined as the process of transferring the right of the assignor to the assignee who would then have the right to proceed against the debtor. The assignment may be done

gratuitously or onerously, in which case, it has an effect similar to that of a sale. (Rodriguez vs. Court of Appeals, 207 SCRA 533 [1992]; NYCO Sales Corp. vs. BA Finance Corp., 200 SCRA 637 [1991]; Licaros vs. Gatmaitan, 362 SCRA 548 [2001].)

(1) In conventional subrogation, a credit is extinguished and another appears, which the new creditor claims as his own, while in assignment of credit, there is a transfer of same credit which belonged to another and which, upon being transferred, is not extinguished.

(2) In conventional subrogation, the consent of the debtor is required so that it may fully produce legal effects, while in assignment of credit, it is not, his knowledge thereof affecting only the validity of the payment he might make. (see Art. 1626.) What the law requires in an assignment of credit is merely notice to the debtor as the assignment takes effect only from the time he has knowledge thereof.

(3) The effects of conventional subrogation begin from the time of novation itself, that is, from the moment all the parties have given their consent, while in assignment of credit, the effects with respect to the debtor begin from the date of notification. (see Art. 1626.)

(4) In conventional subrogation, the nullity or defects of the previous obligation may be cured by the novation, while in assignment of credit, the nullity or defects of the obligation are not remedied, because only the correlative right of the obligation is transmitted.

The rules governing conventional subrogation are, of course, different from those governing assignment of credit.

**ART. 1302. It is presumed that there is legal subrogation:**

**(1) When a creditor pays another creditor who is preferred, even without the debtor's knowledge;**

**(2) When a third person, not interested in the obligation, pays with the express or tacit approval of the debtor;**

**(3) When, even without the knowledge of the debtor, a person interested in the fulfillment of the obligation pays, without prejudice to the effects of confusion as to the latter's share. (1210a)**

## Cases of legal subrogation.

In the three cases enumerated, subrogation takes place by opera-

tion of law even without the consent of the parties.[2] Note that the subrogation is produced from payment which may be with or without the debtor's knowledge or approval.

(1) *When a creditor pays another creditor who is preferred* (see Arts. 2236, 2251.) —

EXAMPLE:

A owes B P1,000.00 secured by a first mortgage on the land of A.

A also owes C P2,000.00. This debt is unsecured (or secured by a second mortgage).

Under the law, B, who is a preferred creditor, has preference to payment with respect to the land as against C who is merely an ordinary creditor. (see Arts. 2242 and 2244.) If C pays the debt of A to B, C will be subrogated in B's right so that he can have the mortgage foreclosed in case A fails to pay the P1,000.00 debt.

(2) *When a third person without interest in the obligation pays with the approval of the debtor* —

EXAMPLE:

A owes B P1,000.00.

C pays B with the express or implied consent of A.

In this case, C will be subrogated in the rights of B. (see Arts. 1236-1237; see Philippine National Bank vs. Court of Appeals, 337 SCRA 381 [2000].)

Where the money used to discharge a person's debt rightfully belonged to the debtor, the party paying cannot be considered a third-party payor under Article 1302(2). (Chemphil Export & Import Corp. vs. Court of Appeals, 251 SCRA 257 [1996].)

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[2]In legal contemplation, garnishment is a forced novation by the substitution of creditor: the judgment debtor, who is the original creditor of the garnishee is, through service of the writ of garnishment, substituted by the judgment creditor who thereby becomes creditor of the garnishee. Garnishment is a species of attachment for reaching any property or credits pertaining or payable to a judgment debtor, whereby the person having the same in his possession is ordered by the court, not to pay the money or deliver the property to the judgment debtor, but rather to appear and answer the plaintiff's suit. (Perla Compania de Seguros, Inc. vs. Ramolete, 203 SCRA 487 [1991].)

(3) *When a third person with interest in the obligation pays even without the knowledge of the debtor —*

EXAMPLES:

(1) Suppose in the same example, C is the guarantor of A. C is a person interested in the fulfillment of the obligation of A as he would be benefited by its extinguishment.

If C pays B, even without the knowledge of A, C is subrogated in the rights of B. Confusion takes place in the person of C. Hence, the guaranty is extinguished but the principal obligation still subsists. (Art. 1276.)

(2) A and B are joint debtors of C for the amount of P1,000.00. Without the knowledge of A, B pays the debt of P1,000.00.

In this case, B becomes a creditor of A for P500.00, the latter's share of the debt but not for the remaining P500.00, the portion of the debt which corresponds to B, which is extinguished by confusion or merger of rights. (see Arts. 1277, 1217.)

**ART. 1303. Subrogation transfers to the person subrogated the credit with all the rights thereto appertaining, either against the debtor or against third persons, be they guarantors or possessors of mortgages, subject to stipulation in a conventional subrogation. (1212a)**

## Effect of legal subrogation.

The effect of legal subrogation is to transfer to the new creditor the credit and all the rights and actions that could have been exercised by the former creditor either against the debtor or against third persons, be they guarantors[3] or mortgagors. Simply stated, except only for the change in the person of the creditor, the obligation subsists in all respects as before the novation. (see Art. 1237.)

The effect of legal subrogation as provided in Article 1303 may not be modified by agreement. The effects of conventional subrogation are subject to the stipulation of the parties.

There are distinctions between the right to be subrogated and the right to reimbursement. (see Art. 1237.)

[3]Art. 2080. The guarantors, even though they be solidary, are released from their obligation whenever by some act of the creditor they cannot be subrogated to the rights, mortgages, and preferences of the latter. (1852)

**ART. 1304. A creditor, to whom partial payment has been made, may exercise his right for the remainder, and he shall be preferred to the person who has been subrogated in his place in virtue of the partial payment of the same credit. (1213)**

## Effect of partial subrogation.

The creditor to whom partial payment has been made by the new creditor remains a creditor to the extent of the balance of the debt. In case of insolvency of the debtor, he is given a preferential right under the above article to recover the remainder as against the new creditor.

EXAMPLE:

D is indebted to C for P10,000.00. X pays C P6,000.00 with the consent of D.

There is here partial subrogation as to the amount of P6,000.00. D remains the creditor with respect to the balance of P4,000.00. Thus, two credits subsist. In case of insolvency of D, C is preferred to X, that is, he shall be paid from the assets of A ahead of X.

ILLUSTRATIVE CASE:

*Preferential right of judgment creditor as against surety who made payment.*

*Facts:* B, vendee, executed in favor of S, vendor, a document promising to pay the latter P130,000.00 in four equal installments. B paid the first installment but failed to pay all the others.

S obtained three judgments against B on the three installments. On the first judgment, B appealed, and in order to suspend the execution thereof, B filed a supersedeas bond with C, as surety. Said judgment was affirmed and was eventually satisfied out of the property of C. The property of B, however, was insufficient to satisfy all the judgments. C brought action claiming right of preference in satisfying his credit out of the property of B.

*Issue:* Is C entitled to subrogation in the first judgment obtained by S? If so, does he enjoy a right of preference over the claims of S, the original creditor and the holder of the other two judgments?

*Held:* C is entitled to subrogation in the rights of S in the first judgment but he may not exercise the rights conferred by such subrogation until S has been fully paid the other two judgments.

The three judgments really constitute one debt, the consideration of the contract of purchase and sale of merchandise. That contract is an

indivisible contract and its consideration single and entire. This being the case, the question as to the right of C to subrogation is brought squarely within the well-established doctrine that the surety cannot exercise the rights conferred by subrogation until the debt which the principal debtor owes to the creditor is fully paid. This clearly requires that S must be paid not only the first but also the two other judgments before C can exercise any rights obtained under subrogation. The result thus obtained conforms to justice and equity. *(Molina vs. Somes, 15 Phil. 133 [1910].)*

**Nature of original creditor's right of preference.**

The principles which govern preference between creditors under the Civil Code must be kept in mind. (Arts. 2236-2251.)

Preference creates simply a right of one creditor to *be paid first the proceeds of the sale* of property as against another creditor. It creates no lien on property and, therefore, gives no interest in property, specific or general, to the preferred creditor, but a *preference in application* of the proceeds after the sale. The right of preference is one which can be made effective only by being *asserted and maintained.* If the right claimed is not asserted and maintained, it is lost. (Molina vs. Somes, 31 Phil. 76 [1915].)

ILLUSTRATIVE CASE:

*Abandonment by judgment creditor of his claim of preference in satisfying his credit out of property of debtor by releasing his levy and returning the property to him.*

*Facts:* S and C each had a judgment against B (C by subrogation). The controversy between the two arose when it became necessary to determine whose judgment was entitled to preference with respect to the proceeds of the sale of certain specific property of the judgment debtor B, then in the hands of the sheriff, by virtue of an execution levied under S's judgment. C was awarded judgment by the lower court declaring that he was entitled to preference. (Molina vs. Somes, 15 Phil. 133 [1910], *supra.*)

S appealed, and, at that time or sometime prior thereto, released the levy under his judgment, and the property, which was the subject of the levy, was returned to B. Thereupon, C levied an execution of B's property and which was duly sold in accordance with law. The proceeds of the sale were turned over to him by the sheriff after deducting expenses and fees. S made no attempt to intervene in the proceedings to sell or to present to the sheriff a claim of preference with respect to the proceeds of the sale.

Subsequently, S secured a reversal of the judgment from which he had taken appeal.

*Issue:* Has S the right of preference over the property of B which had been levied upon and sold, or its equivalent?

*Held:* No. An action cannot be maintained to declare a preference either in the general or specific property of a debtor. It must relate to the proceeds of the sale of specific property of the debtor which has been seized by one creditor to satisfy his debt and as to which another creditor is urging his rightly of priority of payment. Preference consists merely in the right to be paid first, out of specific property, not a right to be paid first out of the general property of the debtor.

In this case at bar, S, instead of maintaining his levy, voluntarily released it and returned the property to B. This was in effect, an abandonment by S of any claim of preference, if one had ever been asserted by him. The moment that B received the property from the sheriff he had absolute control of it. He could sell it to whom he pleased and turned the money received therefrom over to C in payment of his judgment, or he could have turned the property over to C as payment or part payment of the judgment. S, having failed to present his claim to the sheriff or having neglected to take some other appropriate proceedings to establish against C his right of preference, and having permitted distribution of the proceeds of the sale without objection or intervention, lost his right of preference over B's property sold under C's execution. *(Molina vs. Somes, 31 Phil. 76 [1915].)*

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# TITLE II

# CONTRACTS

*(Arts. 1305-1422.)*

## Chapter 1

## GENERAL PROVISIONS

**ART. 1305. A contract is a meeting of minds between two persons whereby one binds himself, with respect to the other, to give something or to render some service. (1254a)**

### Meaning of contract.

The above article gives the definition of a contract. It lays emphasis on the meeting of minds between two contracting parties which takes place when an offer by one party is accepted by the other.[1] (Art. 1319.)

In a contract, one or more persons bind himself or themselves with respect to another or others, or reciprocally, to the fulfillment of a prestation to give, to do, or not to do.[2]

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[1]In the present age of modern technology, the courts may take judicial notice that business transactions may be made by individuals through teleconferencing, an interactive group communication (three or more people in two or more locations) through an electronic medium, bringing people together under one roof even though they are separated by hundreds of miles. (Expertravel & Tours, Inc. vs. Court of Appeals, 459 SCRA 147 [2005].)

[2]In a case, where the pivotal legal question presented was whether or not the issuance of a monetary policy by the Central Bank, thereafter implemented by the appropriate resolutions, as to the rate of exchange at which (U.S.) dollars, after being surrendered and sold to it, could be re-acquired, creates a contractual obligation, the Supreme Court held that considering the fundamental meaning of "contracts" under the Civil Law (see Arts. 1305, 1315, 1319.) and the nature of the administrative authority of the Monetary Board to promulgate rules and regulations governing the monetary and banking system of the Philippines, such resolutions are not contracts that give rise to obligations which must be fulfilled by the Central Bank in favor of affected parties. They may be amended or repealed to attain statutory objectives. (Batchelder vs. Central Bank of the Phils., 44 SCRA 45 [1972].) Therefore, the Central Bank

**Number of parties to a contract.**

In a contract, there must be at least two persons or parties, because it is impossible for one to contract with himself.

A single person may create a contract by himself where he represents distinct interests (*e.g.*, his own and that of another for whom he acts as agent, or of two principals for both of whom he acts in a representative capacity) subject to specific prohibitions of law against the presence of adverse or conflicting interests.

For example, guardians, executors, or administrators cannot acquire by purchase property of persons under their guardianship, or property of the estate under their administration. Neither can agents purchase property whose administration or sale has been entrusted to them unless the consent of the principal has been given. (Art. 1491.) Similarly, if an agent has been authorized to lend money at interest, he cannot borrow it without the consent of the principal. But if he has been authorized to borrow money, he may himself be the lender at the current rate of interest. (Art. 1890.)

**Termination or cancellation of pre-existing contract.**

Article 1305 fully covers the case where two persons agree to terminate or cancel a pre-existing contract.

To terminate a contract, there must be some consideration, either in the delivery of money or something else, or in rendering some act or forbearance (Memorandum of the Code Commission, March 8, 1951, pp. 15-16.), subject to stipulation of the parties.

(1) *Termination by stipulation of the parties.* — As a rule, the method of terminating a contract is primarily determined by the stipulation of the parties. The unilateral termination of a contract by a party is violative of the principle of mutuality of contracts ordained in Article 1308. (Home Development Mutual Fund vs. Court of Appeals, 288 SCRA 617 [1998].)

A contract may be superseded by a compromise agreement (see Art. 2028.) provided it is not contrary to law, morals, good customs,

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could not be compelled to resell dollar earnings at the same preferred rate of exchange (P2.00 per U.S. $1.00) at which they were surrendered in view of subsequent Central Bank Circulars that such exchange should be sold at the prevailing market rate.

public order or public policy (Art. 1306.) To be valid, a compromise agreement is merely required by law to be based on real claims and to be actually agreed upon in good faith. (Manila International Airport Authority vs. ALA Industries Corp., 422 SCRA 603 [2004].)

(2) *Termination, by stipulation, at option of one party.* — A contract may provide, however, that it shall come to an end at the option of one, or either of the parties and such stipulation, when fairly entered into, will be enforced if not contrary to equity and good conscience. (13 C.J. 606; see Art. 1308.) Where the contract is for an indefinite term subject to the right of either party to terminate it any time after a written notice of 30 days, it is immaterial that the termination is for cause or without cause, as long as a 30-day written notice is given. It is the unilateral act, without any legal basis or justification, of one party in terminating a contract which will make him liable for damages. (Riser Airconditioning Services Corp. vs. Confield Construction Dev. Corp., 438 SCRA 471 [2004].) But if a party terminating the contract acted in bad faith purposely to injure or prejudice the other, the former may be held liable for damages for abuse of a right under Article 19 of the Civil Code. (see Petrophil Corporation vs. Court of Appeals, 371 SCRA 702 [2001].)

(3) *Termination by one party with conformity of the other.* — Where one party opts to cancel an existing agreement and the other party expresses its conformity thereto, in legal effect, the parties enter into another contract for the dissolution of the previous one, and they are bound by their contract. The dissolution or cancellation of the original agreement necessarily involves restoration of the parties to the *status quo ante* prevailing immediately prior to the execution of the agreement. (Floro Enterprises, Inc. vs. Court of Appeals, 249 SCRA 354 [1995].)

**Distinctions between termination and rescission of a contract.**

To rescind is to declare a contract void in its inception and to put an end to it as though it never were. It is not merely to terminate it and release parties from further obligations to each other but to abrogate it from the beginning and restore the parties to their relative positions which they would have occupied had no contract ever been made.

Termination of a contract is congruent with an action for unlawful

detainer. The termination or cancellation of a contract would necessarily entail enforcement of its terms prior to the declaration of its cancellation in the same way that before a lessee is ejected under a lease contract, he has to fulfill his obligations thereunder that had accrued prior to his ejectment. However, termination of a contract need not undergo judicial intervention. The parties themselves may exercise such option. Only upon disagreement between the parties as to how it should be undertaken may the parties resort to courts. (Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999].)

**Contract and obligation distinguished.**

Contract is one of the sources of obligations.[3] (Art. 1157.) On the other hand, obligation is the legal tie or relation itself that exists after a contract has been entered into. Hence, there can be no contract if there is no obligation. But an obligation may exist without a contract.

**Contract and agreement distinguished.**

There can be no contract in the true sense in the absence of the element of agreement, or of mutual assent of the parties. (Phil. National Bank vs. Court of Appeals, 238 SCRA 20 [1994].)

Contracts are agreements enforceable through legal proceedings. Those agreements which cannot be enforced by action in the courts of justice (like an agreement to go to a dance party) are not contracts but merely *moral* or *social agreements.* An agreement is broader than contract because the former may not have all the elements of a contract. (see Art. 1318.)

So, all contracts are agreements but not all agreements are contracts.

**Importance, basis, and purpose of contract.**

(1) "The movement of the progressive societies has hitherto been a movement from Status to Contract. . . The society of our day is mainly distinguished from that of preceding generations by the largeness of

[3]It is settled that only laws existing at the time of the execution of the contract are applicable thereto and not later statutes, unless the latter are specifically intended to have a retroactive effect. (Valencia vs. Locquiao, 412 SCRA 600 [2003]; Vive Eagle Land, Inc. vs. Court of Appeals, 444 SCRA 445 [2004].)

the space which is occupied in it by Contract." (G. Florendo, The Law of Obligations and Contracts [1936], p. 477, quoting Sir Henry Maine in his "Ancient Law," pp. 182-183.)

(2) Its rational and juridical basis is the limitation of man and his insufficiency to obtain by himself the means necessary for the fulfillment of his purposes.

(3) Its rational and juridical purpose is the corollary of its basis: The attainment by him of those means for the satisfaction of his necessities from the other contracting party. Contract serves as the juridical means of effecting in a practical manner the effectiveness and development of the economic principle of the division of labor. (see 4 Sanchez Roman 150-155.) As has been said: "The reason for it is in the necessity of completing the limitations of man, contract being the most adequate instrument for which the realization of individual and social ends and by which man acquires the means required — for common life and social cooperation." (G. Florendo, *supra*, citing 3 Valverde 220, quoting Akrens.)

**Characteristics of contracts.**

They are:

(1) *Freedom or autonomy of contracts.* — The parties may establish such stipulations, clauses, terms, and conditions as they may deem convenient, provided, they are not contrary to law, morals, good customs, public order, and public policy (Art. 1306.);

(2) *Obligatoriness of contracts.* — Obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith (Arts. 1159, 1315.);

(3) *Mutuality of contracts.* — Contracts must bind both and not one of the contracting parties; their validity or compliance cannot be left to the will of one of them (Art. 1308.);

(4) *Consensuality of contracts.* — Contracts are perfected, as a general rule, by mere consent,[4] and from that moment the parties are bound not only by the fulfillment of what has been expressly stipulated but also to all the consequences which, according to their nature, may be in keeping with good faith, usage and law (Art. 1315.); and

[4]This is true in the case only of consensual contracts. (see Art. 1316.)

(5) *Relativity of contracts.* — Contracts take effect only between the parties, their assigns and heirs, except in cases where the rights and obligations arising from the contract are not transmissible by their nature, or by stipulation, or by provision of law. (Art. 1311.)

**Classifications of contract.**

The following may be mentioned:

(1) *According to name or designation:*
   (a) Nominate; and
   (b) Innominate. (see Art. 1307.)

(2) *According to perfection:*
   (a) Consensual; and
   (b) Real. (see Arts. 1315, 1316.)

(3) *According to cause:*
   (a) Onerous;
   (b) Remuneratory or remunerative; and
   (c) Gratuitous. (see Art. 1350.)

(4) *According to form:*[5]
   (a) Informal or common; and
   (b) Formal or solemn. (see Art. 1356.)

(5) *According to obligatory force:*
   (a) Valid (see Art. 1306.);
   (b) Rescissible (Chapter 6.);
   (c) Voidable (Chapter 7.);
   (d) Unenforceable (Chapter 8.); and
   (e) Void or inexistent. (Chapter 9.)

(6) *According to person obliged:*
   (a) Unilateral; and
   (b) Bilateral. (see Art. 1191.)

[5]A contract may be express or implied. (see Art. 1315.) A *contract implied in fact* is one the existence and terms of which are manifested not by direct or explicit words between the parties but is to be deduced from facts and circumstances, attending the transactions showing a mutual intention to contract. It is a true contract. (University of the Philippines vs. Philab Industries, Inc., 439 SCRA 467 [2004].)

(7) *According to dependence to another contract:*

(a) *Preparatory* (*e.g.*, agency, partnership), when it is entered into as a means to an end;

(b) *Accessory* (*e.g.*, mortgage, guaranty), when it is dependent upon another contract it secures or guarantees for its existence and validity; and

(c) *Principal* (*e.g.*, sale, lease), when it does not depend for its existence and validity upon another contract but is an indispensable condition for the existence of an accessory contract.

(8) *According to risks:*

(a) *Commutative* (*e.g.*, sale, lease), when the undertaking of one party is considered the equivalent of that of the other; and

(b) *Aleatory* (*e.g.*, insurance, sale of a hope[6]), when it depends upon an uncertain event or contingency both as to benefit or loss.[7]

(9) *According to liability:*

(a) *Unilateral* (*e.g.*, commodatum, gratuitous deposit), when it creates an obligation on the part of only one of the parties; and

(b) *Bilateral* (*e.g.*, sale, lease), when it gives rise to reciprocal obligations for both parties.

The kind of contract entered into is not determined, however, by the name or title given to it by the parties but by its nature or character as determined by principles of law. (see Art. 1371.)

**ART. 1306. The contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy. (1255a)**

## Freedom to contract guaranteed.

The freedom to contract is both a constitutional and statutory right.

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[6]Such as sale of sweepstakes tickets. (see Art. 1461.)

[7]Art. 2010. By an aleatory contract, one of the parties or both reciprocally bind themselves to give or to do something in consideration of what the other shall give or do upon the happening of an event which is uncertain, or which is to occur at an indeterminate time. (1790)

The right to enter into contracts is one of the liberties guaranteed to the individual by the Constitution. It also signifies or implies the right to choose with whom one desires to contract. The Constitution prohibits the passage of any law impairing the obligation contracts. (Art. III, Sec. 10 thereof.) However, the constitutional prohibition against the impairment of contractual obligations refers only to legally valid contracts. (San Diego vs. Mun. of Naujan, 107 Phil. 118 [1960].) In appropriate cases, it cannot be invoked as against the right of the state to exercise its police power.[8]

In other words, an individual does not have an absolute right to enter into any kind of contract. (Lozano vs. Martinez, 146 SCRA 323 [1986].) However, because the autonomy or freedom of contract is both a constitutional and statutory right, to uphold the right, courts are enjoined to move with the necessary caution and prudence in holding contracts void. (Gabriel vs. Mateo, 71 Phil. 497 [1941]; GSIS vs. Province of Tarlac, 417 SCRA 60 [2003].) The binding force of a contract must be recognized as far as it is legally possible to do so. (Lopez vs. Vda. De Cuaycong, 74 Phil. 601 [1944]; Heirs of Late Spouses A and E Balite vs. Lim, 446 SCRA 56 [2004].) The legal presumption is always on the validity of contracts.

**Limitations on contractual stipulations.**

There are limitations to the freedom to contract.

(1) *Law.* — It is a fundamental requirement that the contract entered into must be in accordance with, and not repugnant to, an applicable statute. Its terms are embodied in every contract. Without need

[8]*Police power* has been referred to as the power of the state to enact such laws or regulations in relation to persons and property as may promote public health, public morals, public safety and the general welfare and convenience of the people. (see U.S. vs. Gomez, 31 Phil. 218 [1915].) It has been negatively put forth as that inherent and plenary power in the state which enables it to prohibit all things hurtful to the comfort, safety, and welfare of society. (Rubi vs. Provincial Board, 39 Phil. 660 [1919].)

It has been held, however, that in the interpretation of provisions of social legislations, doubts must be resolved in favor of labor, and in their interpretation, courts must not read into the law something it does not suggest particularly when it would be tantamount to an injunction against the execution of new contracts, which would be violative of the fundamental freedom of contract as distinguished from the constitutional prohibition against impairment of contractual obligations. In appropriate instances, social justice may be more compelling and imperious than police power where labor is involved. (Associacion de Agricultores de Talisay-Silay, Inc. vs. Talisay-Silay Milling, 89 SCRA 311 [1979].)

for the parties expressly making reference to it, an existing law enters and forms part of a valid contract; it thus sets limits (Maritime Co. of the Phils. vs. Reparations Commission, 40 SCRA 70 [1971]; see Taurus Taxi Co., Inc. vs. Capital Insurance & Surety Co., Inc., 24 SCRA 454 [1968]; Roman Environmental Dev't. Corp. vs. Court of Appeals, 167 SCRA 540 [1988]; Cuyco vs. Cuyco, 487 SCRA 673 [2006].), counter-balancing the principle of autonomy of contracting parties in Article 1306. (Pakistan International Airlines Corp. vs. Ople, 190 SCRA 90 [1990].)

The parties to a contract are charged with knowledge of the existing law at the time they enter into the contract and at the time it is to become operative, and a person is presumed to be more knowledgeable about the law of his country than an alien. (Communication Materials and Design, Inc. vs. Court of Appeals, 260 SCRA 673 [1996].) Where a contract is entered into by the parties on the basis of the law then obtaining, the repeal or amendment of said law will not affect the terms of the contract, nor impair the rights of the parties hereunder. This rule applies even if one of the contracting parties is the government. (Recaña, Jr. vs. Court of Appeals, 349 SCRA 24 [2001].) Laws in force at the time the contract was made generally govern its interpretation and application. (Banco Filipino Savings and Mortgage Bank vs. Ybañez, 445 SCRA 482 [2004].)

(2) *Police power.* — Public welfare is superior to private rights. When there is no law in existence or when the law is silent, the will of the parties prevails unless their contract contravenes the limitation of morals, good customs, public order, or public policy. The policy of protecting contracts against impairment presupposes the maintenance of a government by virtue of which contractual relations are worthwhile — a government which retains adequate authority to secure the peace and good order of society. In short, all contractual obligations are subject — as an implied reservation therein — to the possible exercise of the police power of the state. Otherwise, important and valuable reforms may be precluded by the simple device of entering into contracts for the purpose of doing that which otherwise may be prohibited.

Far from being an impairment of contractual obligations, the exercise of such power constitutes, therefore, a mere *enforcement* of one of the conditions deemed imposed in all contracts. (Central Bank of the Phil. vs. Cloribel, 44 SCRA 307 [1972]; Anucension vs. National Labor Union, 80 SCRA 350 [1977]; see also Allied Investigation Bureau, Inc. vs. Ople, 91 SCRA 265 [1979].)

The Supreme Court has held that a contract between the school and the student imbued as it is, with public interest, is not an ordinary contract, abandoning an earlier ruling (in Alcaraz vs. PSBA, 161 SCRA 523 [1990].) that enrollment of a student is a semester-to-semester contract and the school may not be compelled to renew the contract, by recognizing instead the right of a student to be enrolled for the entire period required in order to complete his course. (Non vs. Dames II, 185 SCRA 523 [1990]; Isabelo, Jr. vs. Perpetual Help College of Rizal, Inc., 227 SCRA 591 [1993].)

ILLUSTRATIVE CASE:

*Contract restrictions on the use of property are contrary to a municipal resolution passed in the exercise of police power.*

*Facts:* B bought two lots in a subdivision covered by certificates of title on which are annotated certain restrictions on the use of the property, one of which was the lots are exclusively for residential purposes. S, the subdivision owner, filed a suit to stop the construction of a commercial building by B on the ground that it violated the restrictions on the title. B bought the property two years after the area had been declared by a municipal council resolution as a commercial and industrial zone.

S invoked the principle of non-impairment of contracts, contending that the resolution cannot nullify the contractual obligations assumed by B referring to the restrictions incorporated in the deeds of sale and later in the corresponding Transfer Certificates of Title issued to him.

*Issue:* Is the contention of S tenable?

*Held:* No. While non-impairment of contracts is constitutionally guaranteed, the rule is not absolute, since it has to be reconciled with the legitimate exercise of police power, *i.e.*, "the power to prescribe regulations to promote the health, morals, peace, education, good order or safety and general welfare of the people." The resolution in question was obviously passed by the Municipal Council in the exercise of police power. *(Ortigas & Co., Ltd. vs. Feati Bank & Trust Co., 94 SCRA 553 [1979].)*

### Contract must not be contrary to law.

In its specific sense, *law* has been defined as "a rule of conduct, just, obligatory, promulgated by legitimate authority, and of common observance and benefit." (1 Sanchez Roman 3.)

A contract cannot be given effect if it is contrary to law because law is superior to a contract. (Art. 1409[1].) Acts executed against the

provisions of mandatory or prohibitory laws are void, except when the law itself authorizes their validity. (Art. 5.) Although a contract is the law between the parties (Art. 1159.), the contracting parties must respect the law which is deemed to be an integral part of every contract. (see Art. 1315.) The provisions of positive law which regulate contracts are deemed incorporated or written therein and shall limit and govern the relations between the parties. Thus:

(1) A contract intended to circumvent and violate the law is *void ab initio*. Thus, an agreement to convey a homestead only after the lapse of the 5-year period during which under the Public Land Act, the owner was prohibited from transferring his rights, cannot be enforced for it is clearly illegal. (Homeria vs. Casa, 157 SCRA 232, Jan. 22, 1988.)

(2) The lessor cannot be validly a beneficiary of a fire insurance policy taken by a lessee over his merchandise and the provision in the lease contract providing for such automatic assignment of the policy obtained without the prior consent of the lessor is void for being contrary to law and/or public policy under Sections 17, 18, and 25 of the Insurance Code. (Pres. Decree No. 1460, as amended.) The insurer cannot be compelled to pay the proceeds of a fire insurance to a person who has no insurable interest in the property insured. (Chua vs. Court of Appeals, 277 SCRA 690 [1997].)

(3) A waiver by a party of his right to bring an action for future fraud or gross negligence is void as being against the law (Arts. 1171, 1172.) and also public policy. (Art. 1409[1].) A stipulation which excludes one or more partners from any share in the profits or losses is void. (Art. 1799.) Every stipulation exempting the agent from the obligation to render an account to the principal shall be void. (Art. 1891.) The creditor cannot appropriate the things given by way of pledge or mortgage, or dispose of them. Any stipulation to the contrary is null and void. (Art. 2088.) A stipulation forbidding the owner from alienating the immovable mortgaged shall be void. (Art. 2130.)

### Contract must not be contrary to morals.

*Morals* deal with norms of good and right conduct evolved in a community. These norms may differ at different times and places and with each group of people.

Morals or good customs are often embodied in the law (see Arts. 873, 1183.), but the morals or good customs referred to in Article 1306 must refer to those not expressed in legal provisions. (G. Florendo, *op. cit.*, p. 493.)

EXAMPLES:

(1) A contract, whereby X promised to live as the common-law wife of B without the benefit of marriage in consideration of P50,000.00, is immoral and, therefore, void. (see Batarra vs. Marcos, 7 Phil. 156 [1906].)

(2) An agreement to pay usurious interest is contrary to the usury law[9] (Act No. 2655.) and morality. (Ibarra vs. Aveyro, 37 Phil. 273 [1917].)

(3) An agreement whereby X is to render service as a servant to Y without compensation as long as X has not paid his debt is reprehensible and censurable. (see De los Reyes vs. Alojado, 16 Phil. 499 [1910].) It is also contrary to law. (Art. 1689.)

ILLUSTRATIVE CASE:

*Loan of P4,000.00 in Japanese currency is to be repaid the same amount in Philippine currency after the war.*

*Facts:* D borrowed P4,000.00 in Japanese fiat currency from C, promising to repay "the same amount" or the same number of pesos "in Philippine currency" or "in currency prevailing after the war" without any interest, "one year after this date, October 5, 1944."

D contends that the transaction was immoral and against public order because taking advantage of his superior knowledge of war development, C imposed on him the onerous obligation and could now obtain P4,000.00 in return for an investment of P40.00, D's estimate of the value of the Japanese money he borrowed. He further asserts that the contract was contrary to the Usury Law because he would be paying interest greatly in excess of the lawful rates.

*Issue:* Is the contract legal and obligatory?

*Held:* Yes. For the following reasons: *First*, D voluntarily signed the document without having been misled as to its contents and "insofar as knowledge of war events was concerned," both parties were "on equal footing." *Second*, the date of liberation was anybody's guess. *Third*, there was the possibility that upon reoccupation the Philippine Government

[9]Usury is now legally non-existent. (see Art. 1175.)

would not invalidate the Japanese currency, which after all had been forced upon the people in exchange for valuable goods and property. The odds were about even when the parties played their bargaining game.

It is not immoral or against public order for a homeowner to recover P10,000.00 when his house was burned, because he invested only about P100.00 for the insurance policy. And when the holder of a sweepstake ticket who paid only P4.00 luckily obtained the first prize of P100,000.00 or over, the whole business is not immoral or against public order.

D is not paying interest. Precisely, the contract says the money received "will not earn interest." D and C both elected to subject their rights and obligations to a contingency. The gain to C is not interest within the meaning of the Usury Law. Interest is some additional money to be paid in any event, which is not the case here because C might have gotten less if the Japanese occupation had extended to the end of 1945 or if the liberation forces had chosen to permit the circulation of the Japanese notes. *(Roño vs. Gomez, 83 Phil. 890 [1949].)*

### Contract must not be contrary to good customs.

*Customs* consist of habits and practices which through long usage have been followed and enforced by society or some part of it as binding rules of conduct. It has the force of law when recognized and enforced by law. A custom must be proved as a fact, according to the rules of evidence. (Art. 12; see Art. 1376.)

"Good customs are expressly mentioned, although morals are already specified. The spheres of morals and good customs may frequently overlap each other but sometimes they do not." (Report of the Code Commission, p. 134.)

ILLUSTRATIVE CASE:

*Husband and wife entered into an agreement to separate mutually and voluntarily.*

*Facts:* A notary public ratified a document entitled "legal separation," executed by a husband and wife, wherein they agreed that they separated mutually and voluntarily, that they renounced their rights and obligations, and that they authorized each other to remarry, renouncing any action to which they might be entitled and each promising not to be a witness against the other.

*Issue:* Are these covenants valid?

*Held:* No. They "are contrary to law, morals, and *good customs* and tend to subvert the vital foundation of the legitimate family." The notary public is severely censured. (*Biton vs. Momongon, 62 Phil. 7 [1935],* cited in Selenova vs. Mendoza, *infra*.)

### Contract must not be contrary to public order.

*Public order* refers principally to public safety although it has been considered to mean also the public weal.

ILLUSTRATIVE CASE:

*Contract legalizes the commission of adultery or concubinage.*

*Facts:* Judge A was charged with gross ignorance of the law for having prepared and ratified a document extrajudicially liquidating the conjugal partnership of complainant and his wife. One condition of the liquidation was that either spouse (as the case may be) would withdraw the complaint for adultery or concubinage which each had filed against each other and that they waived their "right to prosecute each other for whatever acts of infidelity" either would commit against the other.

*Issue:* Is the agreement valid?

*Held:* No. It contravenes the following provisions of the Civil Code: "Art. 221. The following shall be void and of no effect: (1) Any contract for personal separation between husband and wife; (2) Every extrajudicial agreement during marriage, for the dissolution of the conjugal partnership of gains or of the absolute community of property between husband and wife; x x x." The extrajudicial dissolution of the conjugal partnership without judicial approval is void.

While adultery and concubinage are private crimes, they still remain crimes, and a contract legalizing their commission is contrary to law, morals, and *public order* and as a consequence, not judicially recognizable. Judge A deserves a severe censure for his mistake. *(Selanova vs. Mendoza, Adm. Matter No. 804-C.J., 64 SCRA 69 [1975].)*

### Contract must not be contrary to public policy.

*Public policy* is broader than public order, as the former may refer not only to public safety but also to considerations which are moved by

the common good.[10] (Report of Code Commission, p. 134.) By public policy is intended that principle of law which holds that no subject or citizen can lawfully do that which has a tendency to be injurious to the public or against the public good which may be termed the "policy of the law," or "public policy in relation to the administration of the law." (Rivera vs. Solidbank Corporation, 487 SCRA 512 [2006].)

"In the absence of express legislation or constitutional prohibition, a court, in order to declare a contract void as against public policy, must find that the contract as to the consideration or thing to be done, has a tendency to injure the public, is against the public good, or contravenes some interests of society, or is inconsistent with sound policy and good morals, or tends clearly to undermine the security of individual rights, whether of personal liability or of private property." (Gabriel vs. Monte de Piedad, 71 Phil. 497 [1941]; Phil. Bank of Communications vs. Echiverri, 99 SCRA 508 [1980].)

EXAMPLES:

(1) X stole the car of Y. Later, they entered into a contract whereby Y would not prosecute X in consideration of P1,000.00.

It is to the interest of society that crimes be punished. The agreement between X and Y is, therefore, contrary to public policy because it seeks to prevent or stifle the prosecution of X for theft. To permit X to escape the penalties prescribed by law by the purchase of immunity from Y, a private individual, would result in a manifest perversion of justice. (Arroyo vs. Berwin, 36 Phil. 386 [1917]; Velez vs. Ramas, 40 Phil. 787 [1919]; see also United Gen. Industries, Inc. vs. Paler, 112 SCRA 404 [1982].)

(2) A condition in a contract of sale states: "In case of sale, the buyer shall not sell to others the land sold but only to the seller, or to his heirs or successors for the same price of P5,600.00 when the latter shall be able to pay it."

The condition is contrary to public policy, because it virtually amounts to a perpetual restriction on the right of ownership, specifically the owner's right to freely dispose of his property. Such a prohibition indefinite and unlimited as to time, so much so that it shall continue

[10]Public order signifies the public weal — public policy. (Bough vs. Cantiveros, 40 Phil. 209 [1919].) Essentially, therefore, public order and public policy mean one and the same thing. Public policy is simply the English equivalent of "order *publico*" in Article 1255 of the Civil Code of Spain now Article 1306. (Leal vs. Intermediate Appellate Court, 155 SCRA 994 [1987].)

to be applicable even beyond the lifetime of the original parties to the contract is a nullity. (Leal vs. Intermediate Appellate Court, 155 SCRA 394 [1987].)

(3) In a labor case, 52 employees signed a contingent fee contract whereby they agreed to pay their lawyer 50% of back salaries that may be awarded to them. The validity of a contingent fee contract depends in large measure on the reasonableness of the stipulated fees under the circumstances of each case.

When the courts find that the stipulated amount is excessive or the contract is unreasonable or unconscionable (whenever the amount is by far so disproportionate compared to the value of the services rendered) or is found to have been marred by fraud, mistake, undue influence or suppression of facts on the part of the attorney, public policy demands that said contract be disregarded to protect the client from unreasonable exaction. In such case, *quantum meruit* (as much as he deserves), may be used as basis for determining the lawyer's professional fees. Under the circumstances, a fee of 20% of back salaries was held as a fair settlement. (Sesbreño vs. Court of Appeals, 245 SCRA 30 [1995].)

(4) The charter party between the petitioner and private respondent stipulated that the "owners shall not be responsible for the loss, split, short landing, breakages and any kind of damages to the cargo." The stipulation, in effect, exempts the owner, a private carrier, from liability even for the negligence of its agents.

Is the stipulation valid? Yes. Article 1745 and other Civil Code provisions on common carriers may not be applied unless expressly stipulated by the parties in their charter party. If the petitioner were a common carrier, the stipulation is void as it would be contrary to public policy. (Valenzuela Hardwood & Industrial Supply, Inc. vs. Court of Appeals, 274 SCRA 642 [1997].)

(5) Prompt notice by the cardholder to the credit card company of the loss or theft of his card should be enough to relieve the former of any liability occasioned by the unauthorized use of his stolen or stolen card. To require the cardholder to still pay for unauthorized purchases would simply be unfair and unjust and clearly run against public policy. (Ermitaño vs. Court of Appeals, 306 SCRA 219 [1999].)

ILLUSTRATIVE CASES:

1. *Contract not to engage, within a certain period, in a business competitive with that of the employer.*

*Facts:* X, having engaged in the Philippines in a business directly competitive with that of Y, expressly agreed that within five (5) years

from the date of his contract of employment by Y, he would refrain from doing that every business.

*Issue:* Is the contract void as constituting an unreasonable restraint of trade and, therefore, against public policy?

*Held:* No. Public policy has been defined as being that principle under which freedom of contract or private dealing is restricted for the good of the community. (People's Bank vs. Dalton, 2 Okla. 476.) It is upon this theory that contracts between private individuals which result in unreasonable restraint of trade have frequently been declared void by the American courts.

The modern rule is that the validity of restraint upon trade or employment is to be determined by the intrinsic reasonableness of the restriction in each case rather than by any fixed rule, and that such restriction may be upheld when not contrary to the public welfare and not greater than is necessary to afford a fair and reasonable protection to the party in whose favor it is imposed.

The contract in question is not obnoxious to the rule of reasonableness. While such restraint if imposed as a condition of the employment of a day laborer would at once be rejected as merely arbitrary and wholly unnecessary to the protection of the employer, it does not seem so with respect to an employee whose duties are such as of necessity to give him an insight into the general scope and details of his employer's business. The contract, in this case, considering the circumstances, is not unreasonable. It must, therefore, be enforced. The rule is that the obligations created by contract have the force of law between the contracting parties. (*Ollendorf vs. Abrahamson, 37 Phil. 273 [1917];* see Filipinas Compania de Seguros vs. Mandanas, 7 SCRA 391 [1966].)

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2. *Contract not to engage, within a certain district, in a business during the time while the employer is engaged in the same business within said district.*

*Facts:* X brought action to annul a clause in a contract of employment entered into between X and Y.

In consideration of the employment of X as pharmacist by Y and the monthly salary mentioned in the contract, X agreed "not to open, nor own, nor have any interest directly or indirectly in any drugstore . . . nor have any connection with or be employed by any other drugstore as pharmacist or in any capacity in any drugstore situated within a radius of four miles from the district of Legaspi, municipality of Albay, province of Albay, while Y or his heirs may own or have a drugstore, or an interest

in any other one within the limits of the districts of Legaspi, Albay, and Daraga of the municipality of Albay, Province of Albay."

*Issue:* Are the restrictions placed upon X contrary to public policy?

*Held:* No. The restrictions are strictly limited (a) to a limited district or districts, and (b) during the time while Y or his heirs may own or have opened a drugstore or have an interest in any other one within said limited district. A contract in restraint of trade is valid if the restraint is limited to "a certain time" or within "a certain place." A contract, however, which restrains a man from entering into a trade or business without either a limitation as to time or place, is invalid.

Considering the nature of the business in which Y is engaged, in relation with the limitation placed upon X both as to time and place, such limitation is legal and reasonable and not contrary to public policy.[11] *(Del Castillo vs. Richmond, 45 Phil. 679 [1924];* see Villa Rey Transit vs. Ferrer, 25 SCRA 845 [1968].)

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3. *Contract not to engage, within a certain period, in any business or occupation whatever in the Philippines.*

*Facts:* X is prohibited from engaging in any business or occupation whatever in the Philippines for a period of five (5) years after the termination of his contract of employment without special written permission from Y.

*Issue:* Is this stipulation against public policy?

*Held:* Yes. It is clearly one in undue or unreasonable restraint of trade and, therefore, against public policy. While it is limited as to time and place, it is not as to trade. It would force X to leave the Philippines in order to obtain a livelihood in case Y declined to give the written permission to work elsewhere in the country. *(Ferrazzini vs. Gsell, 34 Phil. 697 [1915].)*

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4. *Warrants of attorney to confess judgment.*

*Facts:* The promissory note signed by D in favor of C stipulates that "I (D) do hereby authorize any attorney in the Philippines, in case this note be not paid at maturity, to appear in my name and confess judgment" for the amount of the note. In an action by C on the note, an attorney associated with C appeared for D and filed a motion confessing judgment.

[11] A non-involvement clause is not necessarily void for being in restraint of trade where there are reasonable limitation as to time, trade, and place. (Tiu vs. Plantinum Plans Phils., Inc., 517 SCRA 101 [2007].)

*Issue:* Is the stipulation in question valid?

*Held:* It is void as against public policy. Warrants of attorney to confess judgment enlarge the field for fraud, because under these instruments the promissor bargains away his right to a day in court, and because the effect of the instrument is to strike down the right to appeal accorded by statute. *(Phil. National Bank vs. Manila Oil Refining & By-Products Co., 43 Phil. 444 [1923];* see Sec. 5, Act No. 2031 [Negotiable Instruments Law].)

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5. *Student waives his right to transfer to another school unless he refunds scholarship grants.*

*Facts:* X, a law student and a consistent recipient of scholarship grants at Y University, was made to sign a waiver of his right to transfer to another school unless he refunds to the university the equivalent of his scholarship grants in cash. Hence, he was not required to pay fees. For the last semester of his fourth year, X enrolled at another university.

X brought action to recover the amount of the refund which he paid, under protest, to Y University in order to secure his transcript of records for the purpose of the bar examinations.

*Issue:* Is the waiver not to transfer to another school contrary to public policy?

*Held:* Yes. Scholarships are awarded in recognition of merit and to help gifted students in whom society has an established interest or a first lien and not to attract and keep brilliant students in school for their propaganda value. To look at scholarship awards as a business scheme designed to increase the business potential of an educational institution is not only inconsistent with sound public policy but also good morals. *(Cui vs. Arellano University, 2 SCRA 205 [1961].)*

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6. *Contract whereby applicant promised to pay commission to one securing approval of application for a government license.*

*Facts:* P authorized A to prosecute an application for a license with the (defunct) Import Control Office for the importation of certain articles, P promising to pay A as commission 10% of the total amount that would be approved. A brought action to recover the commission agreed upon.

*Issue:* Is the contract to pay compensation for A's service contrary to public policy?

*Held:* Yes. Judicial notice may be taken of the fact that this kind of contract sprouted as a result of the controls imposed by the government on imports and dollars allocations, despite the enunciated government

policy that applications for imports and foreign exchange should be considered and acted upon strictly on the basis of merit, which policy is revealed in Sections 15 and 18 of R.A. No. 650. If the granting of import license depends solely upon the merits of each application, certainly the intervention of intermediaries would be unwarranted and uncalled for, as such intervention would serve no other purpose than to influence or possibly corrupt the judgment of the public officials performing an act or service connected with the issuance of import licenses.

A claims that there is no evidence showing that the contract in question has violated any public policy. This claim has no merit. The question whether a contract is against public policy depends upon its purpose and tendency, and not upon the fact that no harm results from it. In other words, all agreements the purpose of which is to create a situation which tends to operate to the detriment of the public interest is against public policy and, therefore, void, whether the purpose of the agreement is or is not effectuated. For a particular undertaking to be against public policy, actual injury need not be shown; it is enough that potentialities for harm are present. (*Sy Suan vs. Regala, 105 Phil. 1024 [1959];* see International Harvester McLeod, Inc. vs. Court of Appeals, 90 SCRA 512 [1979]; Marubeni Corporation vs. Lirag, 362 SCRA 620 [2001].)

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7. *Contract whereby a CFI Judge employed by a private corporation would render services only after office hours.*

*Facts:* X, a judge of the Court of First Instance[12] and Y (a private corporation) entered into a contract of personal and professional services under the terms of which X is "to head Y's legal department with the condition that he would render such services only after office hours.

*Issue:* Is the contract valid?

*Held:* The contract is void because it is against the law (Sec. 35, Rule 138, Rules of Court.) and public policy. The prohibition is based on sound reasons of public policy, for the rights, duties, privileges, and functions of the office of an attorney-at-law are inherently incompatible with the high official functions, duties, powers, discretions, and privileges of a judge of the Court of First Instance. This inhibitory rule makes it obligatory upon the judicial officers concerned to give their full time and attention to their judicial duties, prevent them from extending special favor to their own private interests and assure the public of their impartiality in the

[12]Now, Regional Trial Court.

performance of their functions. These objectives are dictated by a sense of moral decency and the desire to promote the public interest. *(Omico Mining and Industrial Corp. vs. Vallejos, 63 SCRA 285 [1975].)*

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8. *Stipulation in contract of sale of subdivision lots prohibits the establishment of factories in the district where such lots are located.*

*Facts:* S, seller of subdivision lots, inserted in all contracts of sale a prohibition against the establishment of factories in the district where the lots are located. B, purchaser, files a petition to cancel the annotation of the prohibition on the back of her torrens certificate of title, claiming that the restriction is illegal as it impairs her dominical rights and that it is a mere surplusage because there is a zoning ordinance prohibiting factories in the area.

*Issue:* (1) Is the prohibition valid?

(2) What is the effect of the zoning ordinance?

*Held:* (1) Yes. The prohibition is in reality an easement which every owner of real estate may validly impose under Article 688 which provides that the "owner of a piece of land may establish thereon the easements which he may deem suitable, x x x provided he does not contravene the law, public policy or public order."

The limitation is essentially a contractual obligation, which the owner of the subdivision evidently imposed for the purpose of assuring purchasers of the lots therein that the peace and quiet of the place will not be disturbed by the noise and smoke of factories in the vicinity. Of course, it restricts the free use of the parcel of land by the purchaser. However, "while the courts have manifested some disfavor of covenants restricting the use of property, they have generally sustained them when reasonable, and not contrary to public policy."

(2) The existence of the zoning ordinance is immaterial. The ordinance might be repealed at any time; and if so repealed, this prohibition would not be enforceable against new purchasers, who may be ignorant thereof. *(Trias vs. G. Araneta, Inc., 15 SCRA 241 [1965].)*

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9. *Agreement as to venue of action in case of litigation.*

*Facts:* The "Distributorship Agreement," the actionable document invoked in X's complaint against Y provides that "In case of any litigation arising out of this agreement, the venue of any action shall be in the competent courts of the Province of Rizal."

X points out that he had no choice but to sign the agreement, he being practically at the mercy of Y which is allegedly a multinational corporation. He maintains that to enforce the agreement literally would amount to a denial to him of the opportunity to file any suit against Y, because his residence or place of business being in Isabela province.

*Issue:* Is the agreement as to venue contrary to public policy?

*Held:* No. There may be instances when such an agreement may be so oppressive as to effectively deny to the party concerned access to the courts by reason of poverty. The difficulties pictured by X that a poor plaintiff from a distant province may have to encounter in filing suit in a particular place can indeed happen. In such an eventuality and depending on the peculiar circumstances of the case, the Court may declare the agreement to be in effect contrary to public policy — despite that in general, such agreement is allowable — whenever it is shown that the stipulation work injustice by practically denying to the party concerned a fair opportunity to file suit in the place designated by the law.

Considering, however, the nature and volume (P700,000.00) of the business X has with B and the amount sought to be recovered (more than P300,000.00), that is nothing oppressive in his being required to litigate out of his province. His economic condition does not warrant non-enforcement of the stipulation. After all, for practical reasons, there seems to be justification also for Y to see to it that all suits against it be concentrated in the Province of Rizal, as otherwise considering the nationwide extent of its business, it would be greatly inconvenienced if it has to appear in so many provinces everytime an action is filed against it. Both parties agreed to the venue in controversy with eyes wide open. *(Hoechst Philippines, Inc. vs. Torres, 83 SCRA 297 [1978].)*

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10. *Parties operated an arrangement, commonly known as the "kabit system."*

*Facts:* For a consideration, X attached his motorcycle with complete accessories and sidecar to the transportation line of Y who had the franchise so much so that in the registration certificate, Y appeared to be the owner.

X failed to claim any insurance indemnity for damages arising from accidents in which the motorcycle figured because of the failure of Y to comply with his obligation to register the motorcycle.

*Issue:* Is X entitled to relief from the court?

*Held:* No. Under the "*kabit* system," a person who has been granted a certificate of public convenience allows another person who owns motor

vehicles to operate under such franchise for a fee. A certificate of public convenience is a special privilege conferred by the government. Although not outrightly penalized as a criminal offense, the "*kabit* system" is invariably recognized as being contrary to public policy, and therefore, void and inexistent under Article 1409. It is a fundamental principle that the court will not aid either party to enforce an illegal contract but will leave both where it find's them. *(Teja Marketing vs. Intermediate Appellate Court, 148 SCRA 347 [1987].)*

**ART. 1307. Innominate contracts shall be regulated by the stipulations of the parties, by the provisions of Titles I and II of this Book, by the rules governing the most analogous nominate contracts, and by the customs of the place. (n)**

### Classification of contracts according to its name or designation.

They are:

(1) *Nominate contract* or that which has a specific name or designation in law (*e.g.*, commodatum, lease, agency, sale, etc.); and

(2) *Innominate contract* or that which has no specific name or designation in law.

### Kinds of innominate contract.

They are:

(1) *do ut des* (I give that you may give);

(2) *do ut facias* (I give that you may do);

(3) *facio ut des* (I do that you may give); and

(4) *facio ut facias* (I do that you may do).

*Do ut des* is, however, no longer an innominate contract. It has already been given a name of its own, *i.e., barter* or *exchange.* (Art. 1638.)

### Reasons and basis for innominate contracts.

The impossibility of anticipating all forms of agreement on one hand, and the progress of man's sociological and economic relationships on the other, justify this provision. (8 Manresa 623-625.) A contract will not, therefore, be considered invalid for failure to conform strictly to

the standard contracts outlined in the Civil Code provided it has all the elements of a valid contract. (Arts. 1318, 1356.)

Innominate contracts are based on the well-known principle that "no one shall unjustly enrich himself at the expense of another." (Corpus vs. Court of Appeals, 98 SCRA 424 [1980].)

**Rules governing innominate contracts.**

Innominate contracts shall be governed by:

(1) the agreement of the parties;

(2) the provisions of the Civil Code on obligations and contracts;

(3) the rules governing the most analogous contracts; and

(4) the customs of the place.

ILLUSTRATIVE CASES:

1. *Services were rendered and accepted without any contract.*

*Facts:* On various occasions, X rendered services to Y as interpreter of English. No written contract was entered into between the parties for the employment of X as interpreter. There was no evidence as to whether X's services were solicited, by Y or whether they were offered to Y, but there was no question X rendered and Y accepted the benefits of the services.

*Issue:* Is Y under obligation to pay X just compensation for the services?

*Held:* Yes. It was with the express or tacit consent of Y that X rendered him services as interpreter. As it did not appear that X rendered the same gratuitously, Y has the duty to pay X just compensation therefor by virtue of the innominate contract of *facio ut des* implicitly established. The obligations arising from the contract are reciprocal and apart from the general provisions with respect to contracts and obligations, the special provisions concerning contracts for lease of services (Arts. 1689-1731.) are applicable by analogy. *(Perez vs. Pomar, 2 Phil. 682 [1903].)*

*Note:* When a person does not expect to be paid for his services there cannot be a contract implied in fact to make compensation for said services. In the same manner, when the person rendering services has renounced his fees, the services are not demandable obligations. (Aldaba vs. Court of Appeals, 27 SCRA 263 [1969].) On the other hand, where a person fails to render the services paid for, he is under obligation to return the amount paid. (Sta. Ana Hardware & Co. vs. "Y" Shipping Corp., 64 SCRA 654 [1975].)

An attorney-client relationship can be created by implied agreement, as when the attorney actually rendered legal services for a person who is a close friend. The absence of express contract for attorney's fees is no argument against their payment which may also be justified by virtue of the nominate contract of *facio ut des.* (Corpus vs. Court of Appeals, 98 SCRA 424 [1980].)

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2. *Agreement whereby a person would pay the indebtedness of the mortgagor in consideration of the use of the mortgaged property until reimbursement of the amounts paid.*

*Facts:* After the extrajudicial foreclosure by DBP (mortgagee) and sale of the mortgaged lands to it, but within the one (1) year redemption period, R (mortgagor) entered into a contract with B entitled "Deed of Sale with Assumption of Mortgage" under which R sold the lands to B and the latter assumed the mortgage indebtedness. In another document, R was given the option to repurchase the property. B took possession of the property, introduced improvements thereon, and appropriated the produce to himself.

R demanded an accounting of the income of the property, alleging that the true intent of the parties in executing the contracts in question was to create an equitable mortgage. (see Arts. 1602-1605.)

*Issue:* What contract was entered into by the parties?

*Held:* In the light of the foreclosure proceedings and sale of the properties x x x as well as other relevant facts and circumstances x x x, the true intention of the parties is that B would assume and pay the indebtedness of R to DBP, and in consideration therefor, B was given the possession, the enjoyment, and use of the lands until R can reimburse fully B the amounts paid by the latter to DBP.

The agreement is one of those innominate contracts under Article 1307 of the new Civil Code whereby R and B agreed 'to give and to do' certain rights and obligations respecting the lands and the mortgage debts of R which would be acceptable to the bank, but partaking of the nature of antichresis[13] insofar as the principal parties (R and B) are concerned." *(Dizon vs. Gaborro, etc. and Development Bank of the Phils., 83 SCRA 688 [1978].)*

[13]Art. 2132. By the contract of antichresis the creditor acquires the right to receive the fruits of an immovable of his debtor, with the obligation to apply them to the payment of the interest, if owing, and thereafter to the principal of his credit. (1881)

**ART. 1308. The contracts must bind both contracting parties; its validity or compliance cannot be left to the will of one of them. (1256a)**

## Contract binds both contracting parties.

(1) *Principle of mutuality of contract.* — Article 1308 expresses this principle. The ultimate purpose of the principle is to nullify a contract containing a condition which makes its fulfillment or pre-termination dependent exclusively upon the uncontrolled will of one of the contracting parties. (G.F. Equity, Inc. vs. Valenzuela, 462 SCRA 466 [2005].)

A contract is an agreement which gives rise to obligations. It must bind both parties in order that it can be enforced against either. Needless to say, a contract can be renewed, revived, extended, abandoned, renounced, or terminated only by mutual consent of the parties. Without this mutuality and equality between the parties, it cannot be said that the contract has the force of law between them. (Art. 1159.) It is considered repugnant to have one party bound by a contract while leaving the other free from complying therewith.

A party to a contract is liable for damages for breach or violation thereof. (see Art. 1170.) *Breach of contract* is defined as the "failure without legal reason to comply with the terms of the contract" or the "failure without legal excuse to perform any promise which forms the whole or part of the contract. (Cathay Pacific Airways, Ltd. vs. Vasquez, 399 SCRA 207 [2003].)

(2) *Fulfillment or extinguishment of contract.* — A contract containing a condition which makes its fulfillment or extinguishment dependent exclusively upon the uncontrolled will of one of the contracting parties is void. (Garcia vs. Rita Legarda, Inc., 21 SCRA 555 [1967]; Phil. National Bank vs. Court of Appeals, 196 SCRA 536 [1991].)

(a) Thus, a contract of lease which stipulates that the lessor can terminate the lease unilaterally anytime for any cause, or that the lease shall continue for as long as the lessee needs the premises and can pay the rent (see Art. 1182.), or where the lessee is given the sole option to renew the lease (where the period is for an unreasonable length of time and amount of rent has become unconscionably low because of changed conditions) without the same

privilege being given to the lessor is void[14] (see Art. 1267.) because the contract does not bind both of them since the life or continuance of the lease is made to depend exclusively upon the free and uncontrolled will of the lessor or lessee, as the case may be.

(b) Similarly, a loan contract which gives unbridled right to the creditor to unilaterally upwardly adjust the interest on the debtor's loan would completely take away from the debtor the right to assent to an important modification in their contract, and would negate the element of mutuality in contracts ordained in Article 1308. (Phil. National Bank vs. Court of Appeals, 238 SCRA 20 [1994]; Mendoza vs. Court of Appeals, 359 SCRA 438 [2001]; see Salvador vs. Court of Appeals, 426 SCRA 433 [2004]; United Coconut Planters Bank vs. Spouses Baluso, 530 SCRA 567 [2007]; Florendo, Jr. vs. Metropolitan Bank & Trust Company, 532 SCRA 43 [2007]; Equitable PCI Bank vs. Ng Sheung Ngor, 541 SCRA 223 [2007].)

(c) A pre-termination condition which provides that "if the coach in the sole opinion of the corporation facts to exhibit sufficient skill or competitive ability to coach the team, the corporation may terminate the contract" of employment as head coach of a basketball team, clearly transgresses the principle of mutuality of contracts. (G.F. Equity Inc. vs. Valenzona, 462 SCRA 466 [2005].)

(3) *Renunciation or violation of contract.* — It is an elementary rule that no party can renounce or violate the law of the contract unilaterally or without the consent of the other. (Fernandez vs. MRR, 14 Phil. 274 [1909]; 11 Manresa 380-382.) Hence, "its validity or compliance cannot be left to the will of one of them." (Art. 1308; see Art. 1182.) Just as nobody can be forced to enter into a contract, no one may be permitted to change his mind or disavow and go back upon his own acts, or to proceed contrary thereto, to the prejudice of the other party. (Metro Manila Dev. Corp. vs. Jancom Environmental Corp., 375 SCRA 320 [2002]; GSIS vs. Province of Tarlac, 417 SCRA 60 [2003].)

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[14]Generally, such option is binding on the lessor, as forming an integral part of the contract. After all, a lessor is free to give or not the sole right of renewal to the lessee under the same terms and conditions. Mutuality obtains in such a contract and equality exists between the lessor and the lessee since they remain with the same faculties in respect to fulfillment. (Allied Banking Corporation vs. Court of Appeals, 284 SCRA 357 [1998]; see Jespajo Realty Corporation vs. Court of Appeals, 390 SCRA 27 [2002].) The exception is where *Article 1267* is applicable.

(4) *Proof of alleged defect in contract.* — If after a perfect and binding contract has been executed between the parties it occurs to one of them to allege defect as a reason for annulling it, the alleged defect must be conclusively proved since the validity and fulfillment of contracts cannot be left to the will of one of the contracting parties. (Joaquin vs. Mitsumine, 34 Phil. 858 [1916]; Hemedes vs. Court of Appeals, 316 SCRA 347 [1999].) It is the duty of every contracting party to learn and know the contents of a document before he signs and delivers it. (Olbes vs. China Banking Corporation, 484 SCRA 330 [2006].)

(5) *Release of obligor from compliance.* — The mere fact that a party to a contract has made a bad bargain, may not be a ground for setting aside the agreement. (see Art. 1355.) Where, however, the performance of the contract *has become* so difficult as to be manifestly beyond the contemplation of the parties, the obligor may be released therefrom, in whole or in part. (Art. 1267.) The debtor in obligations to do shall also be released when the prestation becomes legally or physically impossible without the fault of the obligor. (Art. 1266.)

ILLUSTRATIVE CASES:

1. *Stipulation where option to cancel contract of employment by employer is made subject to a suspensive condition.*

*Facts:* E was employed by R for a term of two (2) years as superintendent of an oil mill which R contemplated establishing. R was authorized to cancel the contract if certain machinery necessary for starting the mill should for any reason not arrive in Manila within six months.

R cancelled the contract because of the non-arrival of the machinery. E brought an action for damages.

*Issue:* Is the stipulation permitting the cancellation of contract by R a violation of Article 1308?

*Held:* No. Such stipulation does not make either the validity or compliance of the contract dependent upon R. Having agreed that the option shall exist, the exercise of the option is as much in the fulfillment of the contract as any other fact which may have been the subject of the agreement. Indeed, the cancellation of the contract in accordance with conditions agreed upon beforehand is fulfillment.

It is entirely licit to leave fulfillment to the will of either of the parties in the negative form of rescission, for in such case neither is the article infringed nor is there any lack of equality between the parties since they

remain with the same faculties in respect of fulfillment. (*M.D. Taylor vs. Dy Tieng Piao and Tan Liuan, 43 Phil. 873 [1932];* see Phil. Banking Corp. vs. Lui She, 21 SCRA 1270 [1967].)

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2. *Stipulation gives vendor power to cancel contract in case of breach by vendee.*

*Facts:* In a contract to sell subdivision lots, it is stipulated that in case of default of the vendee in the payment of the monthly installments, he should have a month of grace to make the late payment, and an additional period of 90 days to begin from the expiration of the month of grace, to pay all the amounts due, otherwise, the vendor would have the right to declare the contract cancelled.

*Issue:* Is the stipulation violative of Article 1308?

*Held:* No. The ultimate purpose of Article 1308 is to render void a contract containing a condition which makes its fulfillment dependent exclusively upon the uncontrolled will of one of the contracting parties. The stipulation merely gives the vendor the right to declare the contract cancelled and of no effect. This power could not be arbitrarily exercised without the vendee committing the breach of the contract for non-payment of the installments agreed upon. All that the vendee has to do to prevent the vendor from exercising the power to cancel is for him to comply with his part of the contract. *(Garcia vs. Rita Legarda, Inc., 21 SCRA 555 [1967].)*

**ART. 1309. The determination of the performance may be left to a third person, whose decision shall not be binding until it has been made known to both contracting parties. (n)**

## Determination of performance by a third person.

Under the preceding article, compliance with a contract cannot be left to the will of one of the contracting parties. However, under the above provision, the determination of its performance may be left to a third person. (see Arts. 2042-2046.) In such case, the obligation does not depend upon a potestative condition. (see Art. 1182.)

The decision, however, of the third person shall bind the parties only after it has been made known to both of them.

EXAMPLE:

S sold his parcel of land to B. It was agreed that X, a real estate appraiser, would be the one to determine the reasonable price of the land. (see Art. 1469.) X, then, fixed the price after considering all the circumstances and factors affecting the value of the land.

In this case, X must make known his decision to S and B who will be bound by the same.

**ART. 1310. The determination shall not be obligatory if it is evidently inequitable. In such case, the courts shall decide what is equitable under the circumstances. (n)**

### Effect where determination inequitable.

This article is a qualification to Article 1309.

A contracting party is not bound by the determination if it is evidently inequitable or unjust as when the third person acted in bad faith or by mistake. In such case, the courts shall decide what is equitable under the circumstances.

**ART. 1311. Contracts take effect only between the parties, their assigns and heirs, except in case where the rights and obligations arising from the contract are not transmissible by their nature, or by stipulation or by provision of law. The heir is not liable beyond the value of the property he received from the decedent.**

**If a contract should contain some stipulation in favor of a third person, he may demand its fulfillment provided he communicated his acceptance to the obligor before its revocation. A mere incidental benefit or interest of a person is not sufficient. The contracting parties must have clearly and deliberately conferred a favor upon a third person. (1257a)**

### Persons affected by a contract.

(1) *General rule.* — Contracts take effect only between the parties, their assigns and heirs. This means that only the parties, their assigns and heirs can have rights and obligations under a contract. (see Uy Tam and Uy Yet vs. Leonart, 30 Phil. 471 [1915]; Bank of Phil. Islands vs. Concepcion y Hijos, 53 Phil. 806 [1929].) When there is no privity of contract, there is no obligation or liability to speak about and thus, no

cause of action arrests. (Josefa vs. Zhandong Trading Corp., 417 SCRA 269 [2003].)

As a rule, the act, declaration, or omission of a person cannot affect another. (see Rule 130, Sec. 28, Rules of Court.) Under the basic civil law principle of relativity of contracts, a contract can bind only the parties (their heirs or assigns) who had entered into it and cannot favor or prejudice a third person (Ramos vs. Court of Appeals, 302 SCRA 589 [1999]; Union Refinery Corporation vs. Tolentino, Sr., 471 SCRA 613 [2005].), even if he is aware of such contract and has acted with knowledge thereof. (Integrated Packaging Corporation vs. Court of Appeals, 333 SCRA 170 [2000]; University of the Philippines vs. Philab Industries, Inc., 439 SCRA 467 [2004]; Borromeo vs. Court of Appeals, 550 SCRA 269 [2008]; Cantemprate vs. CRS Realty Dev. Corp., 587 SCRA 492 [2009].)

(2) *Real parties in interest.* — Since a contract may be violated only by the parties thereto as against each other, in an action upon the contract, the real parties in interest, either as plaintiff or as defendant, must be parties to said contract. Therefore, a party who has not taken part in it and for whose benefit it was not expressly made, cannot sue or be sued for performance or for cancellation thereof. He cannot maintain an action on it even if the contract performed by the contracting parties would incidentally inure to his benefit. He can do so only if he shows that he has a real interest affected thereby. A "real interest" has been defined as a present substantial interest, as distinguished from a mere expectancy or a future, contingent, subordinate or consequential interest. (Barfel Development Corporation vs. Court of Appeals, 223 SCRA 268 [1993], citing Moreno, Phil. Law Dictionary, 3rd Ed.; Ong Yong vs. Tiu, 401 SCRA 1 [2003]; Gozun vs. Mercado, 511 SCRA 305 [2006].)

EXAMPLE:

D is indebted to C in the amount of P10,000.00. D and C are the parties to the contract.

If C dies, D must pay the heirs of C. If C assigns his credit to X, then D is liable to pay X.

If D dies and Y is the heir, then Y assumes the obligation of D to C. (see Arts. 776, 781.) Y is bound by the contract entered into by D, his predecessor-in-interest, in view of the privity of interest between him and D. The death of a party does not excuse non-performance of a contract

which involves a property right or interest in the subject matter of the contract. The right and the obligation thereunder pass to the personal representative(s) of the deceased.

However, Y is not liable beyond the value of the property he inherits from D, the decedent.[15] (Art. 1311, par. 1.)

ILLUSTRATIVE CASES:

1. *Binding effect on heirs of contract for attorney's fees between deceased and his lawyer.*

*Facts:* C made a contract with D to act as D's lawyer in a lawsuit for the recovery of certain inheritance. After the action was brought, D died and her minor children, on motion of C, were substituted as plaintiffs. Judgment was rendered in favor of the minors.

*Issue:* Is the contract for attorney's fees between C and D binding upon the minors?

*Held:* No. If C proposed to rely on the contract, he should proceed against the estate of D. Inasmuch as the original action resulted to the profit of the minors, C might have a right of action against them for a reasonable compensation for his services upon a *quantum meruit. (Velayo vs. Patricio, 50 Phil. 178 [1927].)*

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2. *Binding effect on a creditor of agreement between debtor and a third party.*

*Facts:* D received a loan from C which he promised to pay within three (3) years. Subsequent to the loan, D transferred to his parents the business in which he had invested the money received from C. After the death of D's father, all or some of his co-heirs had acknowledged the loan as a debt of the estate of the deceased father.

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[15]Sec. 5. *Claims which must be filed under the notice. If not filed, barred; exceptions.* — All claims for money against the decedent, arising from contract, express or implied, whether the same be due, not due, or contingent, all claims for funeral expenses and expenses for the last sickness of the decedent, and judgment for money against the decedent, must be filed within the time limited in the notice; otherwise they are barred forever, except that they may be set forth as counterclaims in any action that the executor or administrator may bring against the claimants. Where an executor or administrator commences an action, or prosecutes an action already commenced by the deceased in his lifetime, the debtor may set forth by answer the claims he has against the decedent, instead of presenting them independently to the court as herein provided, and mutual claims may be set off against each other in such action; and if final judgment is rendered in favor of the defendant, the amount so determined shall be considered the true balance against the estate, as though the claim had been presented directly before the court in the administration proceedings. Claims not yet due, or contingent, may be approved at their present value. (Rule 86, Rules of Court.)

*Issue:* Is the agreement made between D and his parents or between D and his co-heirs binding upon C?

*Held:* No. One who receives a loan of money acquires the ownership thereof and is the one bound to return to the creditor an equal amount. (see Art. 1953.) Contracts that may have been made subsequent to the contract of loan between D and his parents, or between D and his co-heirs, wherein the lender C has not intervened, cannot be alleged against C, on the principle that the force of law of contracts cannot be extended to parties who do not intervene therein. (*Martinez vs. Ramos, 28 Phil. 589 [1914];* see Lopez vs. Enriquez, 16 Phil. 336 [1910].)

(3) *Exceptions.* — The cases when a contract are effective only between the parties are when the rights and obligations arising from the contract are not transmissible:[16]

(a) by their nature (like a contract requiring or involving personal qualifications, as painting, singing, etc.); or

(b) by stipulation (in accordance with the principle of freedom to contract); or

(c) by provision of law (as in agency, partnership, and commodatum, when death extinguishes the legal relationships). (Art. 1178.)

The rights and obligations under paragraphs (a) and (c) are purely personal, which are not transmissible by their nature and by provision of law. Where the service or act is of such a character that it may as well be performed by another, or where the contract by its terms, shows that performance by others was contemplated, death does not terminate the contract or excuse non-performance. The death of a party does not excuse non-performance of a contract which involves a property right (*e.g.*, contract of lease), and the rights and obligations thereunder pass to the personal representatives of the deceased. Similarly, non-performance is not excused by the death of the party when the other party has a property interest in the subject matter of the contract. (DKC Holdings Corporation vs. Court of Appeals, 329 SCRA 666 [2000].)

[16]Unless expressly assumed, labor contracts are not enforceable against the transferee of an enterprise. The reason for this is that labor contracts are *in personam.* Consequently, it has been held that claims for backwages earned from the former employer cannot be filed against the new owner of an enterprise. Nor is the new operator of a business liable for claims for retirement pay of employees. (Robledo vs. National Labor Relations Commission, 238 SCRA 52 [1994].)

ILLUSTRATIVE CASES:

1. *A surety company asked for judgment for the unpaid premiums and documentary stamps affixed to counterbonds, with interest thereon, subscribed by a person who had died.*

*Facts:* C, creditor (surety company), accepted G as solidary guarantor in several counterbonds. G died. C filed a claim against the estate of G.

*Issue:* Is the obligation of a surety or guarantor transmissible to the heirs?

*Held:* Yes. The third exception to the transmissibility of obligations under Article 1311 refers to those cases where the law expressly states that the rights are extinguished by death, as in the case of legal support (Art. 300.), parental authority (Art. 327[1].), usufruct (Art. 603[1].); contracts for a piece of work (Art. 1725.), etc. By contrast, the articles of the Civil Code that regulate guaranty or suretyship (Arts. 2047-2084.) contain no provision that the guaranty is extinguished upon the death of the guarantor or the surety.

The second exception, being contrary to the general rule, should not easily be implied but must be expressly established or at the very least, clearly inferred from the provisions of the contract itself. Because under the law, a person who enters into a contract is deemed to have contracted for himself and his assigns and heirs, it is necessary for him to expressly stipulate to that effect; hence, G's failure to do so is no sign that he intended his bargain to terminate upon his death. *(Estate of K.H. Hemady vs. Luzon Surety Co., Inc., 100 Phil. 388 [1956].)*

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2. *Contract to provide guarding services was entered into by plaintiff's husband who subsequently died.*

*Facts:* X (corporation) entered into a contract whereby it engaged the services of Y, manager and sole owner of a watchman agency (it is not a corporation nor a registered partnership) to guard the former's premises. When Y died, X engaged the services of other guards. W (Y's widow) brought suit against X for breach of the contract with damages for its unexpired term.

*Issue:* Is the contract in question a personal contract, in the sense that the rights and obligations thereunder are intransmissible to the heirs of a party thereto?

*Held:* Yes. The fact that Y was not required to guard the premises of X does not negate the fact that the guarding job was entrusted to him by reason of his personal qualifications. (see Art. 1726.) The failure to specify in the contract the conditions required of the individual guards

and watchmen proves, not that they were of no concern to the company, but that the latter relied upon their proper selection and supervision by Y himself. This trust and confidence X cannot be compelled to repose in Y's wife or heirs, and as to them, the contract is to be deemed not transmissible. *(Javier Security Special Watchman Agency vs. Shell Craft & Button Corp., 7 SCRA 198 [1963].)*

### Cases when strangers or third persons affected by a contract.

A *third person* is one who has not taken part in a contract and is, therefore, a stranger to the contract.

As a general rule, a third person has no rights and obligations under a contract to which he is a stranger. (Art. 1311, par. 1.) He has no legal standing or capacity to demand the enforcement of a contract or assail its validity even if it is admitted that it is defective. (Wolfson vs. Estate of Martinez, 20 Phil. 340 [1911]; MRR vs. Compania Transatlantica, 38 Phil. 875 [1918]; Ibañez vs. Hongkong and Shanghai Bank, 22 Phil. 572 [1912].)

There are cases, however, when third persons may be affected by a contract.[17] They are the following:

(1) In contracts containing a stipulation in favor of a third person (stipulation *pour autrui*) (Art. 1311, par. 2.);

(2) In contracts creating real rights (Art. 1312.);

(3) In contracts entered into to defraud creditors (Art. 1313.);

(4) In contracts which have been violated at the inducement of the third person (Art. 1314.);

(5) In contracts creating "status" (*e.g.*, the resulting status of marriage must be respected, even by strangers, while the contract is in force);

(6) In the quasi-contract of *negotiorum gestio,* the owner is bound in a proper case, by contracts entered into by the "gestor" (unauthorized manager) (Art. 2150.);

[17]Participation in a contract is not an element in considering whether or not a complaint states a clause of action because even a third party outside the contract can have a cause of action against either or both contracting parties. Thus, where respondent (who paid the reconnection fee of former tenant, was in possession of the property supplied with electricity by petitioner when the electric service was disconnected has a cause of action for damages which can be threshed out in a trial on the merits.

(7) In "collective contracts" where the majority rules over the minority (*e.g.*, collective bargaining contracts which affect even non-union members; "suspension of payments" and "compositions" under the Insolvency Law [Act No. 1956, as amended], where creditors are bound by the contracts of the majority); and

(8) Where the situation contemplated in Article 1729[18] obtains. The intention of this article is to protect the laborers and the materialmen from being taken advantage of by unscrupulous contractors and from possible connivance between owners and contractors. Thus, a constructive *vinculum* or contractual privity is created by the provision, by way of exception to the principle underlying Article 1311 between the owner, on the one hand, and those who furnish labor and/or materials, on the other. (Velasco vs. Court of Appeals, 95 SCRA 616 [1980].)

### Meaning of stipulation *pour autrui*.

Stipulation *pour autrui* is a stipulation in a contract clearly and deliberately conferring a favor upon a third person who has a right to demand its fulfillment, provided, he communicates his acceptance to the obligor before its revocation by the obligee or the original parties.

### Classes of stipulations *pour autrui*.

Stipulations in favor of a third person may be divided into two classes, namely:

(1) Those where the stipulation is intended for the sole benefit of such person. This corresponds almost always to the juridical conception of a gift, it being necessary in such case to apply the rules relating to donations in so far as the form of acceptance is concerned; and

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[18]Art. 1729. Those who put their labor upon or furnish materials for a piece of work undertaken by the contractor have an action against the owner up to the amount owing from the latter to the contractor at the time the claim is made. However, the following shall not prejudice the laborers, employees and furnishers of materials:

(1) Payments made by the owner to the contractor before they are due;

(2) Renunciation by the contractor of any amount due him from the owner.

This article is subject to the provisions of special laws. (1597a)

Other examples where the law authorizes a third party to sue on his debtor's contract with another person or to demand its fulfillment: a vendor *a retro* against every possessor whose right is derived from the vendee *a retro* (Art. 1608); lessor against sublessee for rent due and payable to the lessee (Art. 1652); principal against the substitute appointed by the agent, with respect to the obligations which the substitute has contracted (Arts. 1892, 1893.), etc.

(2) Those where an obligation is due from the promisee to the third person which the former seeks to discharge by means of such stipulation, as, for instance, where a transfer of property is coupled with the purchaser's promise to pay a debt owing from the seller to a third person. (Uy Tam and Uy Yet vs. Leonard, 30 Phil. 471 [1915].)

In the first case, the third party is said to be a donee-beneficiary, while in the second, he is called creditor-beneficiary.

**Requisites of stipulation *pour autrui*.**

They are the following:

(1) The contracting parties by their stipulation must have clearly and deliberately conferred a favor upon a third person;

(2) The third person must have communicated his acceptance to the obligor before its revocation by the obligee or the original parties;

(3) The stipulation in favor of the third person should be a part and not the whole of the contract or the contract itself;

(4) The favorable stipulation should not be conditioned or compensated by any kind of obligation whatever; and

(5) Neither of the contracting parties bears the legal representation or authorization of the third party for otherwise the rules on agency will apply. (see Florentino vs. Encarnacion, 79 SCRA 193 [1977]; Young vs. Court of Appeals, 169 SCRA 213 [1989]; Narvaez vs. Alciso, 594 SCRA 60 [2009].)

EXAMPLES:

(1) D owes C P10,000.00 payable after one (1) year at 14% interest. It was agreed that the interest of P1,400.00 would be given to T to whom C is indebted for the same amount.

In this case, T must communicate his acceptance to D before the revocation of the stipulation by the parties in order that the same will be effective. From the moment communication of acceptance is duly made, T becomes a party to the contract. The promisee (C) in a contract containing a stipulation *pour autrui* is entitled to bring an action for its enforcement or to prevent its breach in the same manner as the beneficiary (T) thereof.

(2) An agreement was entered into by B (bank) and C (a business establishment) whereby C shall honor validly issued B's credit cards presented by their corresponding holders in the purchase of goods and/or services supplied by C.

This is a stipulation *pour autrui* conferring a favor upon holders of credit cards validly issued by B. The holder's offer to pay by means of his credit card constitutes not only an acceptance of the said stipulation but also an explicit communication of his acceptance to the obligor, C. (Mandarin Villa, Inc. vs. Court of Appeals, 257 SCRA 538 [1996].)

**Test as to nature of interest of third person in stipulation *pour autrui*.**

To constitute a valid stipulation *pour autrui*, it must be the purpose and intent of the stipulating parties to benefit the third person, and it is not sufficient that the third person may be incidentally benefited by the stipulation. (Florentino vs. Encarnacion, *supra;* Ramos vs. Court of Appeals, 477 SCRA 85 [2006].) Thus, to determine whether the interest of a third person in a contract is a stipulation *pour autrui* or merely an incidental interest is to rely upon the intention of the parties as disclosed by their contract. In applying this test, it matters not whether the stipulation is in the nature of a gift or whether there is an obligation owing from the promisee to the third person. That no such obligation exists may in some degree assist in determining whether the parties intended to benefit a third person. (Uy vs. Court of Appeals, 314 SCRA 69 [1999]; Associated Bank vs. Court of Appeals, 291 SCRA 511 [1998].)

(1) An agent does not have such an interest in a contract as to entitle him to maintain an action upon it because of the non-performance of the contract, in order to obtain his commission or recoup his advances where he does not appear to be a beneficiary of a stipulation *pour autrui.* (Uy vs. Court of Appeals, *supra*.)

(2) The imposition of association fees in the deed restrictions contained in the contract of sale between the purchaser and the seller-subdivision developer cannot be regarded as a stipulation *pour autrui* in favor of the developer. The requisites *(supra.)* are not present. (South Pachem Dev., Inc. vs. Court of Appeals, 447 SCRA 85 [2004]; Bel Air Village Assoc., Inc. vs. Dionisio, 174 SCRA 589 [1989].)

(3) A stipulation in a contract whereby a letter of credit applied for by an importer and granted by a bank is opened by the bank in favor of a foreign beneficiary (exporter) has been held to be in the nature of a stipulation *pour autrui.* (see Vargas Plow Factory, Inc. vs. Central Bank, 27 SCRA 84 [1969].)

(4) The same is true of a contract between a foreign bank and a local bank whereby the former asks the latter to pay an amount to a

beneficiary. (Bank of America vs. Intermediate Appellate Court, 145 SCRA 419 [1986].)

(5) In the performance of its job an arrastre operator is bound by the management contract it executed with the Bureau of Customs. Such contract, which is a sort of a stipulation *pour autrui* is also binding on the consignee because it is incorporated in the gate pass and delivery receipt which must be presented by the consignee before delivery can be effected to it. The insurer, as successor-in-interest of the consignee, is likewise bound by the management contract. (International Container Terminal Services, Inc. vs. FGU Issurance Corp., 556 SCRA 194 [2008].)

ILLUSTRATIVE CASES:

1. *Stipulation in a surety bond that contractor shall promptly pay all persons (third persons), without naming them, supplying labor or materials to such contractor in the performance of his contract with another.*

*Facts:* D, etc. (contractors) entered into a contract with C (City of Manila) for furnishing crushed rock for a period of one year. To secure the performance of the contract, a bond was executed with S as surety. One of the conditions of the bond was that D "shall promptly make all payments to all persons supplying them [D] labor or materials in the prosecution of the work."

T furnished D with certain materials for and in the performance of said contract having previously notified D, C, and S of the condition of the bond relating to laborers and materialmen. Action was brought by T upon the bond.

*Issue:* Did the parties to the bond intend to secure the claims of materialmen?

*Held:* No. A stipulation *pour autrui* must be clearly expressed. A contract of surety is not to be presumed but must be expressed. The bond does not contain words naming the materialmen, etc., as obligees (*e.g.*, "for the benefit of whom it may concern," "for the benefit of materialmen and of any person in interest") and giving them the right to sue thereon. The parties must have clearly and deliberately conferred a favor upon D. *(Uy Tam and Uy Yet vs. Leonard, 30 Phil. 471 [1915].)*

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2. *Stipulation whereby purchaser of mortgaged property assumes the indebtedness of mortgagor to mortgagee (third person).*

*Facts:* C (bank) brought action to recover upon a promissory note and to foreclose the mortgage securing the same, executed by D. During

the pendency of the action, D transferred the properties mortgaged to X who agreed with D to assume the mortgage debts.

X subsequently notified C of the sale and of his assumption of the obligation, to which notice C made no reply.

*Issue:* Is the assumption by X of the obligation of D in favor of C as provided for in the contract between X and D, a stipulation *pour autrui* upon which C may maintain an action?

*Held:* No. D owed C a large sum of money and wanted to be relieved of that obligation. X wanted the property which had been mortgaged to secure that obligation, and had to assume the obligation and agree to secure the discharge of D therefrom, in order to get the property. Neither of them had any desire to confer any benefit to C. Neither of them entered into the contract for the sake of C. Each entered into the contract impelled by the advantage accruing to him personally as a result thereof.

Even assuming that the stipulation was intended for the benefit of C, the latter is nevertheless not in a position to maintain its action against X in view of the fact that such stipulation was not accepted by it. *(Bank of the Phil. Islands vs. V. Concepcion E. Hijos, Inc., 53 Phil. 806 [1929].)*

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3. *Stipulation in a motor vehicle accident policy that insurer will indemnify the authorized driver of the insured or the driver's personal representatives (third persons).*

*Facts:* X (insurer) issued to Y (Taxicab Company) a common carrier accident policy. The heirs of T, a driver of one of the vehicles covered by the policy, who was killed brought action against X to collect the proceeds of said policy in view of the failure of X and Y to agree with respect to the amount to be paid to said heirs.

X claims that the heirs had no cause of action as they had no contractual relation with T.

*Issue:* Does the policy in question belong to contracts *pour autrui*?

*Held:* Yes. The policy provides, *inter alia*, that X "will indemnify any authorized driver who is driving the motor vehicle" of the insured and, in the event of death of said driver, X shall, likewise, "indemnify his personal representatives." Thus, the policy is typical of contracts *pour autrui*, this character being made more manifest by the fact that the deceased driver, paid 50% of the premiums, which were deducted from his weekly commissions. *(Coquia vs. Fieldmen's Ins. Co., 26 SCRA 178 [1968].)*

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4. *Stipulation in an insurance policy authorizes owner of damaged vehicle to contract for its repair with any repairman (third person).*

*Facts:* The clause in an insurance policy authorizes the owner of the damaged vehicle to contract for its repair.

*Issue:* Does that mean the repairman is entitled to collect the cost of repair out of the proceeds of the insurance.

*Held:* No. Such stipulation merely establishes the procedure that the insured has to follow in order to be entitled to indemnity for repair. It should not, therefore, be construed as bringing into existence in favor of the repairman a right of action against the insurer as such intention can never be inferred therefrom. In the case at bar, the insurance contract does not contain any words or clauses to disclose an intent to give any benefit to any repairmen or materialmen in case of repair of the car in question. *(Bonifacio Bros. vs. Mora, 20 SCRA 261 [1967].)*

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5. *Stipulation in a management contract limits liability of one of the parties to importers or consignees of cargoes (third persons) up to a specified amount.*

*Facts:* Paragraph 15 of the management contract entered into between MPS (Manila Port Service) and the Bureau of Customs pursuant to law limits the former's liability for loss, etc. to any cargo while under its custody or control to P500.00 for each package, unless the value be otherwise specified or manifested and the corresponding arrastre charges have been paid.

*Issue:* Is this provision binding upon a consignee of cargo claiming damages who was not a party to the contract or signatory thereof?

*Held:* Yes. Said provision is in the nature of a stipulation *pour autrui,* that is, for the benefit or in favor of a third party, the consignee in the case at bar. By virtue thereof, MPS is expected to render service, not to the Bureau of Customs but specifically and principally to the importers or consignees of cargoes. Upon the importer's or consignee's compliance with certain conditions, namely, presentation of approved delivery permits, payment of arrastre fees, etc., he is entitled to receive, and MPS is obliged to deliver, the cargoes corresponding to those described in the delivery permit of the importer or consignee.

There can scarcely be any doubt that by said provision in the contract, MPS and the Bureau of Customs deliberately and purposely confer benefit upon every consignee because it is to the latter that the merchandise is to be delivered in good order and payment made, in the event of loss, etc., thereof while in the control or custody of MPS. *(Smith, Bell & Co., Ltd. vs. Manila Port Service, 1 SCRA 1007 [1961].)*

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6. *Stipulation in a contract to sell binds buyer to hold the seller free from all claims of a third person who had previously offered to buy the same property.*

*Facts:* T and B both offered to buy a lot belonging to S. Adjudging that B was the first to have accepted its conditions, S entered into a contract to sell with B. T brought suit to have the contract annulled, alleging, among other things, that the contract to sell contained a stipulation for her benefit which reads: "x x x that the buyer B has been fully informed by S of all the circumstances relative to the offer of T to buy said lot and that he agrees and binds himself to hold S absolutely free and harmless from all claims and damages of T in connection with this sale of the lot to him."

*Issue:* Does the contract to sell contain a stipulation in favor of T?

*Held:* No. The clause in question cannot by any stretch of the imagination be considered as a clause *"pour autrui"* or for the benefit of T. The stipulation does not confer any right arising from the contract that may be enforced by T against any of the parties thereto. Neither does it impose any obligation arising from the contract that may be enforced by any of the parties thereto against T. *(Cronico vs. J.M. Tuazon & Co., Inc. and Ramirez, 78 SCRA 331 [1977].)*

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7. *Stipulation in a bond holds surety liable to the government in case a private school does not comply with its obligations to its teachers and employees (third persons).*

*Facts:* By the term of a bond, the surety guaranteed to the Government (Department of Education) compliance by a private school "with all its obligations, including the payment of the salaries of its teachers and employees." The Government filed an action on the bond on account of its violation by the school in not paying the salaries of two of its teachers.

The surety argues that it is not liable to the teachers because the latter are not parties to the bond nor are they beneficiaries of a stipulation *pour autrui*.

*Issue:* Is the argument tenable?

*Held:* No. It is based on the false premise that the teachers are trying to enforce the obligation of the bond. The action is not one by the teacher against the surety, but one brought by the Government to hold the surety liable on its bond. *(General Insurance & Surety Corp. vs. Republic, 7 SCRA 4 [1963].)*

**Other instances where benefit to third person merely incidental.**

Under the law, it is not every promise made by one to another, from the performance of which a benefit may ensue to a third person, which gives a right of action to such third person, he being neither privy to the contract nor to the consideration. (Simson vs. Brower, 68 N.Y., 355.) The contracting parties must have clearly and deliberately conferred a favor upon such third person. (Art. 1311, par. 2.) "It would be going too far to hold that a mere stranger to the contract, who was to derive only an incidental benefit therefrom, might recover for a breach of such contract." (Crandall vs. Paine, 154 Ill. 627.)

Thus, it has also been held:

(1) A contract between the United States and a state for the maintenance of a canal cannot be enforced by one who has made use of water furnished from such canal. (Walsh vs. C.H.V. & Athens R. Co., 176 U.S. 469.)

(2) A contract between an employer and employee, whereby the former agreed to furnish the latter a physician if the employee was injured in the course of employment, could not be enforced by a physician whom the employee engaged. (Thomas Mfg. Co. vs. Prather, 65 Ark. 27.)

(3) A contract with a city to furnish water for fire protection cannot be a basis of an action against the contractor for non-observance by the inhabitants of the city who have only an incidental benefit therein. (Allen & Currency Mfg. Co. vs. Shreveport Waterworks Co., 113 La. 1091.)

(4) A contract by an employer with a physician to attend to all his sick and injured employees gives the employees no right of action against the physician for breach of contract. (*Ibid*., citing a French case.)

(5) A contract by which a person agreed with a receiver to pay the debt of a corporation which bought a boatload of coal, and before having paid for it, was put in the hands of the said receiver, cannot be enforced by the seller of the coal. (*Ibid.*, citing a French case; Uy Tam and Uy Yet vs. Leonard, 30 Phil. 471 [1915].)

**Nature and form of acceptance of stipulation.**

(1) The acceptance must be unconditional (Art. 1319; see Bank of

P.I. vs. Concepcion y Hijos, Inc., 53 Phil. 806 [1929].) and made before the stipulation is revoked. (Florentino vs. Encarnacion, 79 SCRA 193 [1977].)

(2) The "acceptance does not have to be in any particular form, even when the stipulation is for the third person an act of liberality or generosity on the part of the promissor or promisee." It may be implied (*Ibid.*, citing Tolentino, Civil Code of the Philippines, Vol. 1 [1973], p. 410, citing 6 Planiol & Ripert 500.) from the demand for the performance of the stipulation. "It need not be made expressly and formally. Notification of acceptance, other than such as is involved in the making of demand, is unnecessary." (*Ibid.*, citing Poblete vs. Lo Singco, 44 Phil. 369 [1923].)

A stipulation *pour autrui* may be accepted any time before it is revoked, unless a definite period for acceptance has been fixed.

ILLUSTRATIVE CASES:

1. *Revocation of stipulation in favor of a third person was unilaterally made by debtor who received valuable consideration from creditor.*

*Facts:* D (bank), for a valuable consideration paid by C, agreed to cause a sum of money to be paid to T in New York.

*Issue:* Can T maintain an action against D for the non-performance of said undertaking.

*Held:* Yes. The promise of D is a stipulation within the meaning of paragraph 2, Article 1311. A third person seeking to enforce compliance with a stipulation in his favor must signify his acceptance before it has been revoked. In this case, T clearly signified his acceptance to D by demanding payment; and although D had already directed its New York Agency to withhold payment when this demand was made, the right of T cannot be considered prejudiced by that fact.

The word "revocation," as there used, must be understood to imply revocation by the mutual consent of the contracting parties, or at least by direction of C (obligee), the party who purchased the exchange. (*Kauffman vs. Phil. National Bank, 42 Phil. 182 [1921];* see Constantino vs. Espiritu, 39 SCRA 206 [1971].)

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2. *Third party (Church) had impliedly accepted stipulation before it was sought to be revoked, by enjoying the benefits flowing therefrom for many years.*

*Facts:* X and Y are the common and pro-indiviso owners in fee simple of a parcel of land. They filed with the CFI an application for

the registration of the property under Act No. 496. The land has been adjudicated to them by virtue of a deed of extrajudicial partition. According to the deed, the fruits of the property shall answer for the expenses of certain religious functions.

During the trial, X asked the trial court that this stipulation be included as encumbrance on the land and that it be entered on the face of the title. Y opposed the motion. The court decided for Y, ruling that the stipulation was revocable at the unilateral option of the co-owners.

It appears that from the time of the death of the previous owner of the property in 1941, as had always been the case since time immemorial, up to a year before the filing of the application in May 1964, the Church had been enjoying the benefits of the stipulation.

*Issue:* Whether the stipulation can be revoked or should be annotated as an encumbrance on the face of the certificate of title.

*Held:* Considering its nature and purpose, the stipulation is a stipulation *pour autrui.* While a stipulation in favor of a third person has no binding effect in itself before its acceptance by the party favored, the law does not provide when the third person must make his acceptance. As a rule, there is no time limit; such third person has all the time until the stipulation is revoked.

Here, the Church accepted the stipulation in its favor before it is sought to be revoked by Y. The enjoyment of benefits flowing from the stipulation for almost seventeen (17) years without question from any quarters can only be construed as an implied acceptance by the Church of the stipulation *pour autrui* before its revocation. *(Florentino vs. Encarnacion, supra.)*

### Acceptance of stipulation includes its concurrent obligations.

When a third person accepts the benefits of a contract to which he is not a party, he is also bound to accept the concomitant obligations corresponding thereto. He should not take advantage of the contract when it suits him to do so, and rejects its provisions when he thinks they are prejudicial or onerous to him. (Bernabe and Co., Inc. vs. Delgado Bros., Inc., 107 Phil. 287 [1960]; Northern Motors, Inc. vs. Prince Line, 107 Phil. 253 [1960].)

ILLUSTRATIVE CASE:

*Right of third person to enforce stipulation is subject to the condition that it must be exercised by him within a certain period.*

*Facts:* Paragraph 15 of the management contract between the Manila Port Service (MPS) and the Bureau of Customs provides that the MPS shall be released from responsibility for loss, damage, etc., of goods unless suit is brought "within one (1) year from the date of discharge of the goods, or from the date when the claim for the value of such goods have been rejected or denied by the contractor, provided that such claim shall have been filed with the contractor with 15 days from the date of the discharge of the last package from the carrying vessel."

The management contract was incorporated by reference in the gate passes and delivery permits which were used by the customs broker of S Company to obtain delivery of the cargo from MPS.

S Company brought action against MPS for damages under said paragraph 15 of the management contract although it did not file any claim within the 15-day period.

*Issue:* Is MPS liable to S Company?

*Held*: No. Paragraph 15 contains a stipulation for the liability of MPS, the arrastre service contractor, to consignees of goods. It is a sort of stipulation *pour autrui.* The management contract is enforceable against S Company because it was incorporated in the gate passes and delivery permits. S Company cannot be permitted to take advantage of the favorable provisions of paragraph 15 and reject those that are disadvantageous to it. The filing of the claim within the 15-day period was a condition precedent to the institution of the suit for damages. (*Shell Chemical Company vs. Manila Port Service, 72 SCRA [1976];* but see Manila Port Service vs. Court of Appeals, 20 SCRA 1214.)

**ART. 1312. In contracts creating real rights, third persons who come into possession of the object of the contract are bound thereby, subject to the provisions of the Mortgage Law and the Land Registration Laws.[19] (n)**

## Third persons bound by contracts creating real rights.

This article is an exception to the general rule that a contract binds only the parties.

[19]Presidential Decree No. 1529, the Property Registration Decree, superseded Act No. 496, as amended, the Land Registration Act. The Mortgage Law referred to is the Spanish Mortgage Law of 1893, which was more a law on registration than on mortgaging, covering property with Spanish titles or possessory information titles. The system of registration under the law has been discontinued by the Property Registration Decree.

Third persons who come into possession of the object of a contract over which there is a real right, such as a real estate mortgage, are bound thereby even if they were not parties to the contract. A real right is binding against the whole world and attaches to the property over which it is exercised wherever it goes. Thus, a contract subjecting certain real properties to the payment of certain debts, registered in accordance with the Property Registration Decree, constitutes a real right, which is produced not by the contract but by the publicity given by the Registry, such publicity prejudicing the right of third persons. (Decisions of the Supreme Court of Spain, May 23, 1899; Dec. 12, 1900.)

If the real right is not registered, third persons who acted in good faith are protected under the provisions of the Property Registration Decree.

It is well-known in our jurisdiction that persons dealing with registered land have the legal right to rely on the face of the Torrens Certificate of Title (TCT) and to dispense with the need to inquire further, except when the party concerned has actual knowledge of facts and circumstances that would impel a reasonably cautious man to make such inquiry. (Seno vs. Mangabote, 156 SCRA 113 [1987]; Naawan Community Rural Bank, Inc. vs. Court of Appeals, 395 SCRA 43 [2003].)

**ART. 1313. Creditors are protected in cases of contracts intended to defraud them. (n)**

### Right of creditor to impugn contracts intended to defraud them.

Article 1313 is another qualification to the rule that contracts take effect only between the parties.

The creditor, although he is not a party to the contract, is given the right to impugn the contracts of his debtor intended to defraud him (Art. 1177.), such as contracts undertaken by a debtor in fraud of his creditor without the knowledge of the latter. (see Art. 1381[3].) He can sue to rescind the contract to prevent fraud upon him.

### Right of creditor to enforce contracts of debtor with a third person.

In some cases, the law gives a right of action to a creditor to enforce a contract entered into by his debtor with a third person. Thus:

(1) Those who put their labor upon or furnish materials for a piece of work undertaken by the contractor have an action against the owner up to the amount owing from the latter to the contractor at the time the claim is made. (Art. 1729.)

(2) The lessor may recover rent due from a sublessee since the sublessee is subsidiarily liable to the lessor for any rent due from the lessee. (Art. 1652.)

**ART. 1314. Any third person who induces another to violate his contract shall be liable for damages to the other contracting party.**

### Liability of third person responsible for breach of contract.

This is a rule of American law. It is also proper under the general principles of the Philippine law, because a contractual right is property. (Report of the Code Commission, p. 135.)

Article 1314 recognizes an instance when a stranger to a contract can be sued for damages for his unwarranted interference with the contract. The tort or wrongful conduct is known as "interference with contractual relations." It presupposes that the contract interfered with is valid and the third person has knowledge of the existence of the contract or must have known of it after a reasonable inquiry.

The word "induce" in the provision refers to situations where a person causes another to choose one course of conduct by persuasion or intimidation. The interfence or inducement gives rise to liabilities for damages because it violates the property rights of a party in a contract to reap the benefits that should result therefrom. (Lagon vs. Court of Appeals, 453 SCRA 616 [2005].) Injunction is the appropriate remedy to prevent a wrongful interference with contracts by strangers to such contracts where the legal remedy is insufficient and the resulting injury is irreparable. (Yu vs. Court of Appeals, 217 SCRA 328 [1993].)

EXAMPLE:

After agreeing to sell his parcel of land to B, S sells the land to C instead because of the inducement of D.

In this case, B can sue D for damages. However, the liability of D for damages cannot be more than that of S for the latter's violation of

his contract. To hold D liable for damages in excess of those that can be recovered against S "would lead to a result at once grotesque and unjust." (Daywalt vs. Corporacion de LP. Agustinos Recoletos, 39 Phil. 587 [1919].) At most, D would be solidarily liable with S.

What would be the source of the obligation of D? His liability will be based on the theory of quasi-delict. (see Art. 1157[5]; see People's Bank & Trust Co. vs. Dahican Lumber Co., 20 SCRA 84 [1967].) The responsibility of two or more persons who are liable for a quasi-delict is solidary. (Art. 2194.)

**Malice not necessary.**

Malice in some form is generally supposed to be an essential ingredient in cases of interference with contract relations.

Upon the authorities, it is enough if the wrongdoer, having knowledge of the existence of the contract relation, in bad faith sets about to break it up. Whether his motive is to benefit himself or gratify his spite by working mischief to a contracting party is immaterial. Malice in the sense of ill-will or spite is not essential. (Daywalt vs. Corporacion de LP. Agustinos Recoletos, *supra*; see Jardine Davies, Inc. vs. Court of Appeals, 333 SCRA 684 [2000]; see Tayag vs. Lacson, 426 SCRA 282 [2004].) It is sufficient that the defendant must have been driven by purely impious reasons to injure the plaintiff. In other words, his act cannot be justified. (Lagon vs. Court of Appeals, *supra*.)

**Where legal justification exists.**

A third person is not liable where sufficient justification for interference or inducement can be shown.

(1) Thus, it was said that if a party enters into a contract to go with another upon a journey to a remote and unhealthful climate, and a third person with a *bona fide* purpose of benefiting the one who is under contract to go, dissuades him from the step, no action will lie. But if the advice is not disinterested and the persuasion is used for the indirect purpose of benefiting himself at the expense of the other contracting party, the intermeddler is liable if his advice is taken and the contract broken. *(Ibid.)*

(2) Similarly, an unpaid seller commits no act of unlawful interference in giving notice to a prospective buyer of property that the unpaid seller has not yet been paid by the vendor who brought

the real property from him and that he still have the option to rescind the sale of the property to the vendor. (Rubio vs. Court of Appeals, 141 SCRA 488 [1986].)

ILLUSTRATIVE CASE:

*Interference with a contract of lease was motivated by interferer's own financial or economic interest, rather than by wrongful and malicious motives.*

*Facts:* R, lessor sent a letter to E, lessee, informing the latter of a 50% increase in rent, enclosing in the letter new lease contracts for signing. R warned that failure of E to accomplish the contracts shall be deemed as lack of interest on the lessee's part and agreement to the termination of the lease. E did not answer the letter, but the lease contracts were not rescinded.

T, petitioner, requested formal contracts of lease with R for his own textile business, TM. The lease contracts in favor of TM were executed.

In the suit for injunction, E pressed for the nullification of the lease contracts between R and T. E also claimed damages.

*Issue:* Is T guilty of tortious interference with contract and liable for attorney's fees.

*Held:* Yes. "The foregoing issues involve, essentially, the correct interpretation of the applicable law on tortuous conduct, particularly unlawful interference with contract. We have to begin, obviously, with certain fundamental principles on torts and damages."

(1) *Liability for a non-trespassory invasion of another's property.* — "Damage is the loss, hurt, or harm which results from injury, and damages are the recompense or compensation awarded for the damage suffered. One becomes liable in an action for damages for a nontrespassory invasion of another's interest in the private use and enjoyment of asset if: (a) the other has property rights and privileges with respect to the use or enjoyment interfered with, (b) the invasion is substantial, (c) the defendant's conduct is a legal cause of the invasion, and (d) the invasion is either intentional and unreasonable or unintentional and actionable under general negligence rules."

(2) *Elements of tort interference.* — "The elements of tort interference are: (1) existence of a valid contract; (2) knowledge on the part of the third person of the existence of contract; and (3) interference of the third person is without legal justification or excuse."

(3) *Elements are present.* — "A duty which the law of torts is concerned with is respect for the property of others, and a cause of action

*ex delicto* may be predicated upon an unlawful interference by one person of the enjoyment by the other of his private property. This may pertain to a situation where a third person induces a party to renege on or violate his undertaking under a contract. In the case before us, petitioner TM asked R to execute lease contracts in its favor, and as a result, petitioner deprived E corporation of the latter's property right. Clearly, and as correctly viewed by the appellate court, the three elements of tort interference above-mentioned are present in the instant case."

(4) *Justification for interference.* — "Authorities debate on whether interference may be justified where the defendant acts for the sole purpose of furthering his own financial or economic interest. One view is that, as a general rule, justification for interfering with the business relations of another exists where the actor's motive is to benefit himself. Such justification does not exist where his sole motive is to cause harm to the other. Added to this, some authorities believe that it is not necessary that the interferer's interest outweigh that of the party whose rights are invaded, and that an individual acts under an economic interest that is substantial, not merely *de minimis*, such that wrongful and malicious motives are negatived, for he acts in self-protection. Moreover, justification for protecting one's financial position should not be made to depend on a comparison of his economic interest in the subject matter with that of others. It is sufficient if the impetus of his conduct lies in a proper business interest rather than in wrongful motives.

As early as *Gilchrist vs. Cuddy* (29 Phil. 542, 549 [1915].), we held that where there was no malice in the interference of a contract, and the impulse behind one's conduct lies in a proper business interest rather than in wrongful motives, a party cannot be a malicious interferer. Where the alleged interferer is financially interested, and such interest motivates his conduct, it cannot be said that he is an officious or malicious intermeddler."

(5) *Extent for damages.* — "In the instant case, it is clear that petitioner T prevailed upon R, to lease the warehouse to his enterprise at the expense of E. Though petitioner took interest in the property of respondent corporation and benefited from it, nothing on record imputes deliberate wrongful motives or malice on him.

Article 1314 of the Civil Code categorically provides also that, 'Any third person who induces another to violate his contract shall be liable for damages to the other contracting party.' Petitioner argues that damage is an essential element of tort interference, and since the trial court and the appellate court ruled that private respondents were not entitled to actual,

moral or exemplary damages, it follows that he ought to be absolved of any liability, including attorney's fees.

It is true that the lower courts did not award damages, but this was only because the extent of damages was not quantifiable. We had a similar situation in *Gilchrist*, where it was difficult or impossible to determine the extent of damage and there was nothing on record to serve as basis thereof. In that case we refrained from awarding damages. We believe the same conclusion applies in this case."

(6) *Liability for damages.* — "While we do not encourage tort interferers seeking their economic interest to intrude into existing contracts at the expense of others, however, we find that the conduct herein complained of did not transcend the limits forbidding an obligatory award for damages in the absence of any malice. The business desire is there to make some gain to the detriment of the contracting parties. Lack of malice, however, precludes damages. But it does not relieve petitioner of the legal liability for entering into contracts and causing breach of existing ones. The respondent appellate court correctly confirmed the permanent injunction and nullification of the lease contracts between R and TM, without awarding damages. The injunction saved the respondents from further damage or injury caused by petitioner's interference."

(7) *Liability for attorney's fees.* — "Lastly, the recovery of attorney's fees in the concept of actual or compensatory damages, is allowed under the circumstances provided for in Article 2208 of the Civil Code. One such occasion is when the defendant's act or omission has compelled the plaintiff to litigate with third persons or to incur expenses to protect his interest. But we have consistently held that the award of considerable damages should have clear factual and legal bases. x x x

Considering that the respondent corporation's lease contract, at the time when the cause of action accrued, ran only on a month to month basis whence before it was on a yearly basis, we find even the reduced amount of attorney's fees ordered by the Court of Appeals still exorbitant in the light of prevailing jurisprudence. Consequently, the amount of two hundred thousand (P200,000.00) awarded by respondent appellate court should be reduced to one hundred thousand (P100,000.00) pesos as the reasonable award for attorney's fees in favor of E." *(So Ping Bun vs. Court of Appeals, 314 SCRA 751 [1999].)*

**ART. 1315. Contracts are perfected by mere consent, and from that moment the parties are bound not only to the fulfillment of what has been expressly stipulated but also to all the consequences which, according to their nature, may be in keeping with good faith, usage and law. (1258)**

**ART. 1316. Real contracts, such as deposit, pledge and commodatum, are not perfected until the delivery of the object of the obligation. (n)**

### Classification of contracts according to perfection.

They are:

(1) *Consensual contract* or that which is perfected by mere consent (*e.g.*, sale, lease, agency) (Art. 1315.);

(2) *Real contract* or that which is perfected, in addition to the above, by the delivery of the thing subject matter of the contract (*e.g.,* depositum, pledge, commodatum) (Art. 1316; see Arts. 1934, 1963, 2093.); and

(3) *Solemn contract* or that which requires compliance with certain formalities prescribed by law such prescribed form being thereby an essential element thereof (*e.g.*, donation of real property).

### Stages in the life of a contract.

A contract undergoes three (3) distinct stages. They are:

(1) *Preparation or negotiation.* — This includes all the steps taken by the prospective parties from the time they manifest interest in entering into a contract, leading to the perfection of the contract. At this stage, the parties have not yet arrived at any definite agreement. They are yet undergoing the preliminary steps towards the formation of a valid contract. Either party may stop the negotiation or withdraw an offer made;

(2) *Perfection or birth.* — This takes place when the parties have come to a definite agreement or meeting of the minds regarding the terms, that is, the subject matter and cause of the (consensual) contract (Art. 1319.), *i.e.,* upon concurrence of the essential elements of the contract; and

(3) *Consummation or termination.* — This takes place when the parties have fulfilled or performed their respective obligations or undertakings under the contract and the contract may be said to have been fully accomplished or executed, resulting in the extinguishment thereof.

Once a contract is shown to have been consummated or fully performed by the parties thereto, its existence and binding effect can no

longer be disputed. (Weldon Construction Corp. vs. Court of Appeals, 154 SCRA 618 [1987].)

**How contracts are perfected.**

(1) *Consensual contracts.* — As a general rule, contracts are perfected by mere consent of the parties regarding the subject matter and the cause of the contract.[20] (Arts. 1315, 1319.) They are obligatory in whatever form they may have been entered into, provided, all the essential requisites for their validity are present. (Art. 1356.)

Almost all contracts are consensual as to perfection. They come into existence upon their perfection by mutual consent even if the parties have not affixed their signatures to its written form, and even if the subject matter or the consideration has not been delivered, barring law or stipulation to the contrary. (see Vargas Plow Factory, Inc. vs. Central Bank, 27 SCRA 84 [1969].) In the absence of delivery, perfection does not transfer title or create real right, yet, it gives rise to obligation binding upon both parties. (Arts. 1305, 1308.)

ILLUSTRATIVE CASES:

1. *The document with respect to sale of motor vehicle contains provision for down payment without mentioning the full purchase price and the manner the installments were to be paid.*

*Facts:* The following document was executed and signed by petitioners' sales representative.

"Agreements between Mr. Sosa and Popong Bernardo of Toyota Shaw, Inc.

1. All necessary documents will be submitted to Toyota Shaw, Inc. (Popong Bernardo) a week after upon arrival of Mr. Sosa from the Province (Marinduque) where the unit will be used on the 19th of June.

2. The down payment of P100,000.00 will be paid by Mr. Sosa on June 15, 1989.

[20]A compromise agreement is a contract. It becomes binding between the parties upon its execution and not upon its court approval. (Santos Ventura Hocorma Foundation, Inc. vs. Santos, 441 SCRA 472 [2004].)

3. The Toyota Shaw, Inc. Lite Ace yellow, will be pick-up [sic] and released by Toyota Shaw, Inc. on the 17th of June at 10 a.m.

Very truly yours,

(Sgd.) Popong Bernardo''

After waiting for about an hour on June 17, 1989 for pick-up of the vehicle, Bernardo told Sosa that the vehicle could not be delivered.

*Issues:* In its petition for review by certiorari of the decision of the Court of Appeals affirming that of the trial court which took the view that the document was a perfected contract of sale[21] binding upon petitioner Toyota, it also raised the following related issues:

(a) whether or not the standard Vehicle Sales Proposal (VSP) was the true and documented understanding of sale;

(b) whether or not Sosa has any legal and demandable right to the delivery of the vehicle despite the non-payment of the consideration and the non-approval of his credit application by B.A. Finance;

(c) whether or not Toyota acted in good faith when it did not release the vehicle to Sosa; and

(d) whether or not Toyota may be held liable for damages.

*Held:* (1) *Document not a contract of sale.* — "What is clear from Exhibit 'A' is not what the trial court and the Court of Appeals appear to see. It is not a contract of sale. No obligation on the part of Toyota to transfer ownership of a determinate thing to Sosa and no correlative obligation on the part of the latter to pay therefor a price certain appears therein. The provision on the down payment of P100,000.00 made no specific reference to a sale of a vehicle. If it was intended for a contract of sale, it could only refer to a sale on installment basis, as the VSP executed the following day confirmed. But nothing was mentioned about the full purchase price and the manner the installments were to be paid.

This Court had already ruled that a definite agreement on the manner of payment of the price is an essential element in the formation

[21]Art. 1458. By the contract of sale one of the contracting parties obligates himself to transfer the ownership of and to deliver a determinate thing, and the other to pay therefor a price certain in money or its equivalent.

A contract of sale may be absolute or conditional. (1445a)

Art. 1475. The contract of sale is perfected at the moment there is a meeting of minds upon the thing which is the object of the contract and upon the price.

From that moment, the parties may reciprocally demand performance, subject to the provisions of the law governing the form of contracts. (1450a)

of a binding and enforceable contract of sale. This is so because the agreement as to the manner of payment goes into the price such that a disagreement on the manner of payment is tantamount to a failure to agree on the price. Definiteness as to the price is an essential element of a binding agreement to sell personal property."

(2) *Document merely at generation or negotiation stage of a contract of sale.* — "At the most, Exhibit 'A' may be considered as part of the initial phase of the generation or negotiation stage of a contract of sale. x x x The second phase of the generation or negotiation stage in this case was the execution of the VSP. It must be emphasized that thereunder, the down payment of the purchase price was P53,148.00 while the balance to be paid on installment should be financed by B.A. Finance Corporation. It is, of course, to be assumed that B.A. Finance Corp. was acceptable to Toyota, otherwise it should not have mentioned B.A. Finance in the VSP. x x x

Accordingly, in a sale on installment basis which is financed by a financing company, three parties are thus involved: the buyer who executes a note or notes for the unpaid balance of the price of the thing purchased on installment, the seller who assigns the notes or discounts them with a financing company, and the financing company which is subrogated in the place of the seller, as the creditor of the installment buyer. Since B.A. Finance did not approve Sosa's application, there was then no meeting of minds on the sale on installment basis. x x x

The VSP was a mere *proposal* which was aborted in lieu of subsequent events. It follows that the VSP created no demandable right in favor of Sosa for the delivery of the vehicle to him, and its non-delivery did not cause any legally indemnifiable injury."

(3) *Respondent not entitled to damages and attorney's fees.* — "The award then of moral and exemplary damages and attorney's fees and costs of suit is without legal basis. x x x Since Sosa is not entitled to moral damages and there being no award for temperate, liquidated, or compensatory damages, he is likewise not entitled to exemplary damages. Under Article 2229 of the Civil Code, exemplary or corrective damages are imposed by way of example or correction for the public good, in addition to moral, temperate, liquidated, or compensatory damages." *(Toyota Shaw, Inc. vs. Court of Appeals, 244 SCRA 320 [1995].)*

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2. *A party seeks to avoid a perfected contract by reason of mistake to which the other in no way contributed.*

*Facts:* The Armed Forces of the Philippines, through the Office of the Chief of Engineers, offered to pay M the amount of P15,000.00 as

rentals for its use of a parcel of land belonging to her, even enclosing in its offer a quit claim agreement for M's signature, which offer M accepted. M signed and returned the agreement to the offeror.

*Subsequently*, the armed forces were reorganized and the authority to sign contracts of lease was transferred to the Chief of Staff who refused to sign the agreement because it was found that the damage to M's property did not warrant the payment to her of the aforesaid amount and offered instead the amount of P3,300.00 in full satisfaction of M's claim which M refused.

*Issue:* Has M the right to ask for the fulfillment of her agreement with the AFP for the payment to her of the amount of P15,000.00?

*Held:* Yes. The contract was perfected from the time the AFP received M's acceptance of its offer. It is elementary that a contract, once perfected, is binding on both parties, and its validity or compliance cannot be left to the will of one of them. (Art. 1308.)

The absence of a writing does not preclude the binding effect of the contract duly perfected by a meeting of the minds, the contract not being of the class called "formal" or "solemn" in which writing is essential to their binding effect. Nor may contracts deliberately entered into be overturned by reason of mistake of one of the parties to which the other in no way contributed. *(Vda. de Murciano vs. The Auditor General, 103 Phil. 907 [1958].)*

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3. *Parties agreed on the price and terms of payment but buyer did not sign the contract to sell because it covered seven (7) lots while their agreement was only for six (6) lots.*

C, a manufacturing company, had a factory beside that of D, a developer. In its desire to expand, C offered to buy six (6) adjacent subdivision lots of D with a total area of 1,453 square meters. After negotiations, the parties signed a Contract to Sell where C will pay a total down payment of P2,906 and a monthly installment of P402.86 for the six lots over a period of 10 years.

Among the provisions in their contract is that should C fail to pay any of the monthly installments within 120 days from its due date, or breach any of the other conditions of the contract, the contract shall become null and void without necessity of notice to C or of any judicial declaration to that effect and D shall be at liberty to dispose of the said lots to any other person.

C thus made the down payment and took possession of six (6) lots. In 10 years time, however, due to fire, strike and other calamities, C had

only paid eight (8) monthly installments although it continued to remain in possession of the lots. Eventually, D wrote C a letter demanding that it remove its encroachments on said lots as the Contract to Sell over the same had been considered already cancelled way back when it failed to pay the monthly installments.

After a series of talks and negotiations, C and D agreed to enter into a new Contract to Sell. The new contract price for the seven (7) lots would be P423,250 with a down payment of P42,325 and the balance payable 48 monthly installments of P7,395.94. The draft of the new Contract to Sell was then sent to C. But the president of C did not sign the draft contract although he sent five (5) checks covering the down payment totalling P37,542.72. D received these checks but did not encash it because C president did not sign the draft contract prepared by D. According to C president, he did not sign the draft because it covered lots with a total area of 1,693 square meters while their agreement was only for six (6) lots. The seventh lot was meant only as a right of way.

Since no new written contract was signed, D sued the C for recovery of possession of the lots still occupied by the latter. C, for its defense, said that a new Contract to Sell has already been perfected even if no document evidencing the same has been signed. It contended that D's offer to sell had been accepted by C as in fact it had sent five (5) checks as down payment which was duly received. The non-encashment thereof cannot serve to belie the fact of its tender as down payment. The unsigned draft itself may be deemed to embody the new agreement between the parties. It was not signed only because it covered seven (7) lots instead of six (6).

*Issue:* Was C correct in its argument that a new Contract to Sell had already been perfected?

*Held:* (1) *Parties had not arrived at a definite agreement on number of lots to be sold.* — "Based on the facts, the parties had not arrived at a definite agreement. The only agreement they arrived at was the price indicated in the draft contract. But the number of lots to be sold is a material component of the Contract to Sell. Without an agreement on the matter, the parties may not in any way be considered as having arrived at a contract under the law."

(2) *Contract to sell involves performance of an obligation.* — "Moreover, since the five (5) checks were not encashed, C should have deposited the corresponding amounts of the said checks as well as the installments agreed upon. A Contract to Sell, as in this case, involves the performance of an obligation not merely the exercise of a privilege or a right. Consequently, performance or payment may be effected not by tender of payment alone but by both tender and consignation. It is consignation

which is essential to extinguish C's obligation to pay the balance of the purchase price."

(3) *C did not even bother to make consignation or to have contract amended.* — "In this case, C did not lift a finger towards the performance of the contract either through the tender of down payment. It did not even bother to tender and make consignation of the installments or to amend the contract to reflect the true intention of the parties as regards the number of lots to be sold. Indeed by C's inaction, D cannot be judicially ordered to validate or honor the new Contract to Sell. It ignored opportunities to resuscitate the original Contract to Sell rendered inoperative by its own inaction." *(People's Industrial & Commercial Corp. vs. Court of Appeals, 281 SCRA 206 [1997].)*

(2) *Real contracts.* — The exceptions are the so-called real contracts which are perfected not merely by consent but by the delivery, actual or constructive, of the object of the obligation (Art. 1316.), as in a pledge, *mutuum* (simple loan) or commodatum. These contracts have for their purpose restitution, because they contemplate the return by a party of what has been received from another or its equivalent.

EXAMPLE:

X borrowed from Y P5,000. As X's security for the debt, X promised to pledge his diamond ring to Y.

Before the delivery of the ring to Y, the contract of pledge is not yet perfected. If X later on refuses to pledge the ring, Y can demand the payment of the obligation although it is with a period. (Art. 1198[2].) But Y cannot require X to deliver the ring as security because there is no real contract of pledge yet. There is merely a *consensual* contract to constitute a pledge. What exists, is a personal right, the right of action on the part of Y to demand the constitution of the pledge. (see Art. 2092.)

Similarly, while a perfected loan contract is binding upon the parties and can give rise to an action for damages, said contract does not, however, constitute the real contract of loan which requires the delivery of the object of the contract for its perfection (see Art. 1934.) and which gives rise to obligations only on the part of the borrower. (BPI Investment Corp. vs. Court of Appeals, 377 SCRA 117 [2002].)

(3) *Solemn contracts.* — When the law requires that a contract be in some form to be valid (Art. 1356.), this special form is necessary for its perfection, the prescribed form being thereby an essential requisite of the contract.

Thus, a donation of real property cannot be perfected until it is embodied in a public instrument. (Art. 749.) But, except in the case of statutory forms or solemn agreements, it is the assent and concurrence ("the meeting of the minds") of the parties, and not the setting down of its terms, that constitutes a binding contract. (Montelibano vs. Bacolod-Murcia Milling Co., Inc., 5 SCRA 36 [1962].)

**Effect of perfection of the contract.**

Until the contract is perfected, it cannot, as an independent source of obligation, serve as a binding juridical relation.[22] (Asuncion vs. Court of Appeals, 238 SCRA 601 [1994].) Unaccepted offers and proposals remain as such and cannot be considered as binding commitments; hence, not demandable. (Luxuria Homes, Inc. vs. Court of Appeals, 302 SCRA 315 [1999].)

From the moment the parties come to an agreement on a definite subject matter and valid consideration (Batchelder vs. Central Bank of the Phil., 44 SCRA 45 [1972]; see Villongco Realty Co. vs. Bormacheco, Inc., 65 SCRA 352 [1975].), they are bound not only:

(1) to the fulfillment of what has been expressly stipulated but also,

(2) to all the consequences which according to their nature, may be in keeping with good faith, usage, and law. (Art. 1315.)

Signing is not, generally, a legal requirement in entering into a contract where there is a meeting of the minds. (Art. 1319, par. 1.) Consent may be either be express or implied, unless the law specifically requires a particular manner or form of expressing such consent. One who approved or authorized such contract may be considered a party and held equally liable.[23]

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[22]Notwithstanding the absence of a perfected contract, between the parties, their relationship may be governed by *other existing laws* which provide for their reciprocal rights and obligations. (National Housing Authority vs. Grace Baptist Church, 424 SCRA 147 [2004].)

[23]For example, even if the consignee is not a signatory to the contract of carriage between the shipper and the carrier, the consignee can be bound by the contract. To begin with, there is no question of the right in principle, of a consignee in a bill of lading to recover from the carrier or shipper for loss of, or damage to goods being transported under said bill, although that document may have been — as in purchase it oftentimes is — drawn up only by the consignor and the carrier without the intervention of the consignee. This is particularly true where the consignee formally claims reimbursement for missing goods from the shipper based on the very same bill of lading. (Everett Steamship Corporation vs. Court of Appeals, 297 SCRA 496 [1998].)

ILLUSTRATIVE CASES:

*Unpaid seller of property seeks to be protected in his possession as against the mortgagee of the buyer (mortgagor) who executed a dacion en pago in favor of the mortgagee in consideration of the payment of the loan.*

*Facts:* Petitioner FGRD (mortgagee) seeks to dispossess *pendente lite* respondent (seller) SA of the subject parcel land on the strength of a *dacion en pago* executed in favor of FGRD by Camacho spouses EC and AC (mortgagor) who, in turn, had purportedly bought the property from SA.

Respondent's complaint in the trial court seeks the following: the rescission of the Deed of Absolute Sale between himself and the Camacho spouses, the annulment of the *dacion en pago* executed by the latter in favor of petitioner, and the cancellation of petitioner's certificate of title to it as well as the issuance of a new one in favor of respondent.

The factual findings of both the trial and the appellate courts show that respondent intended to sell the subject property to the Camacho spouses for the sum of P2,500,000. The couple initially paid P100,000, with the agreement that the balance would be paid when they would have secured a loan using the subject property as collateral. To facilitate their procurement of a loan, the title to the property was transferred to them.

Using the subject property as collateral, the Camachos were able to obtain a loan of P1,190,000 from petitioner. Upon the former's failure to pay the loan, the latter sought to foreclose the mortgage over it. However, before the property could be foreclosed, petitioner and the couple allegedly agreed on a *dacion en pago*, in which the latter ceded ownership of the property in favor of the former in consideration of the payment of the loan. Respondent contends that when petitioner conducted an on-site investigation of the property in connection with the couple's application for a loan, the latter learned that the former was living in the subject premises and was thus in actual possession of it. The Court of Appeals found, in fact, that petitioner was aware that respondent — the previous owner — remained an unpaid seller..

*Issue:* Has the FGRD the right to disposses SA *pendente lite* through the issuance of a preliminary injunction?

*Held:* No. FGRD failed to show a clear right to possess. To disposses SA *pendente lite* would be clearly unjust.

(1) *Prima facie right to possess.* — "Indeed, the records show that the *dacion en pago* signed in 1994 was registered only in 1997. It was executed in lieu of the foreclosure of the property when the Camachos

failed to pay their loan obligations. The amount stated in the *dacion* as consideration was the P1,190,000 loan that they had obtained from petitioner. It is therefore strange that the couple would buy a parcel of land for P2,500,000, obtain a loan to help finance payment for the same, and finally cede the same property for an amount much lower than that for which they purchased it. Moreover, by executing a *dacion*, the seller effectively waived the redemption period normally given a mortgagor.

In sum, we hold that respondent was able to show a *prima facie* right to the relief demanded in his Complaint. The Camachos' nonpayment of the purchase price agreed upon and the irregularities surrounding the *dacion en pago* are serious enough to allow him to possess the property *pendente lite*."

(2) *Grave injustice in a transfer of possession*. — "In addition, respondent has shown that to allow petitioner to take immediate possession of the property would result in grave injustice. As we have stated above, the ownership of the property, the validity of the sale between respondent and the Camachos and the legitimacy of the *dacion en pago* executed by the latter in favor of petitioner are still subject to determination in the court below. Furthermore, there is no question that respondent has been in possession of the premises during all this time — prior to and during the institution of the Complaint. He and his family have long owned, possessed and occupied it as their family home since 1967. To dispossess him of it now would definitely alter the status quo to their detriment."

(3) *Ineffectual judgment*. — "By selling their family home to the Camachos for P2,500,000, the respondent hoped to improve the plight of his family. By a strange turn of events, he will now find himself homeless with only the sum of P100,000 to purchase a new dwelling for himself and his relatives. Indeed, justice and equity dictate that he should remain in possession of the property *pendente lite." (First Global Realty and Development Corporation vs. San Agustin, 377 SCRA 341 [2002].)*

**Guide for performance of contract.**

The ordinary meaning of *execution* of a contract is not limited to the signing or concluding of the contract but includes as well the performance or implementation or accomplishment of all terms and conditions of such contract. (Eastern Assurance & Security Corp. vs. Intermediate Appellate Court, 179 SCRA 561 [1989].) Good faith and regularity are always presumed in the execution of contracts. The burden of proving otherwise falls on the party claiming it. (Guillen vs. Court of Appeals, 179 SCRA 789 [1989].)

(1) *Scope and limit of contractual obligation.* — Article 1315 takes up the question of the scope and limit of the contractual obligation in regard to its prestation. It is obvious that the parties rarely, if ever, stipulate each and every detail of the performance or non-performance desired by them. Often, only the bare skeleton of the contract is stipulated, leaving so much of the details to be furnished in its performance by the good faith of the parties.

This article furnishes the guide to the settlement of the question which may arise between the parties in the absence of stipulation. The first to be determined in such cases is the nature of the contract, and once this is determined, the obligation arising from the same shall be performed in accordance with good faith, usage, and law. (G. Florendo, *op. cit.*, p. 825; see Uy Tam and Uy Yet vs. Leonard, 30 Phil. 471 [1915].)

Aside from the express contract, an implied one may arise from the conduct of the parties. Thus, in a case, although the distributor was not under any contractual obligation under the distributorship agreement to provide free storage for the products of the manufacturer, an implied contract of storage which justified liability for storage charges or fees by the manufacturer was held to have arisen by the conduct of the parties. (Bayer Philippines, Inc. vs. Court of Appeals, 340 SCRA 437 [2000].)

(2) *Observance of terms and conditions thereof.* — A judicial or quasi-judicial body cannot impose upon the parties a judgment different from their real agreement or against the terms and conditions thereof without running the risk of contravening the principle established in Article 1159 that a contract is the law between the parties. (Phil. Bank of Communications vs. Echiverri, 99 SCRA 508 [1980].)

A court, for example, gravely abuses its discretion in compelling a college to re-open and admit striking students for enrollment in the second semester of their courses. (Capitol Medical Center, Inc. vs. Court of Appeals, 178 SCRA 493 [1989].) When a school accepts students for enrollment there is established an implied contract between them, resulting in bilateral obligations, which the parties are bound to comply with. For its part, the school undertakes to provide the student with an education that would presumably suffice to equip him with the necessary tools and skills to pursue higher education or a profession. On the other hand, the student covenants to abide by the

school's academic requirements and observe its rules and regulations. (Phil. School of Business Adm. vs. Court of Appeals, 205 SCRA 729 [1992]; see Soliman, Jr. vs. Tuazon, 209 SCRA 47 [1992].)

(3) *Condition imposed on perfection of contract/performance of obligation.* — A distinction exists between a condition imposed on the perfection of a contract and a condition imposed merely for the performance of an obligation. While failure to comply with the first condition results in the failure of a contract, failure to comply with the second merely gives the other party options and/or remedies to protect his interests. (see Babasa vs. Court of Appeals, 290 SCRA 532 [1998]; Jardine Davies, Inc. vs. Court of Appeals, 333 SCRA 684 [2000].)

(4) *Adjustment of rights of parties by court.* — In the exercise of its equity jurisdiction, the court may adjust the rights of parties in accordance with the circumstances obtaining at the time of rendition of judgment, when these are significantly different from those existing at the time of generation of those rights. Adjustment of rights has been held to be particularly applicable when there has been a depreciation of the currency. (see Agcaoili vs. GSIS, 165 SCRA 1 [1988].) Courts have no power, however, to amend or modify the stipulations of the parties. Thus, stipulations clearly intended to cover contract price adjustments arising from "extra-work, alteration, or variation orders" cannot be made to apply to other monetary claims arising from other causes such as a modification of the stipulated compliance "term or period." The first involves a deviation from construction plans or specifications unlike lengthening of the completion period which in effect, is a "binding modificatory novation of the contract." (R-II B Builders, Inc. vs. Construction Industry Arbitration Commission, 475 SCRA 79 [2006].)

**Pertinent provisions of law deemed incorporated in contracts.**

The rights and obligations of the parties to an agreement are not determined solely by the terms thereof. Any agreement or contract to be enforceable in this jurisdiction is understood to incorporate therein the pertinent provision or provisions of law specifying the rights and obligations of the parties under such contract. (Commissioner of Internal Revenue vs. United States Lines Co., 5 SCRA 175 [1962].)

Stated otherwise, an existing law enters into and forms part of a valid contract without the need for the parties expressly making

reference to it. The freedom of contract recognized by the Civil Code (Art. 1306.), while it empowers the parties to establish such stipulations, clauses, terms and conditions as they may deem convenient, is limited by the requirement that they should not be "contrary to law." (Lakas ng Manggagawang Makabayan [LMM] vs. Abiera, 36 SCRA 437 [1970]; Maritime Co. of the Phil. vs. Reparations Commission, 40 SCRA 70 [1971].)

Thus, the right of redemption in favor of a holder of free patent, being a statutory right, forms part and is deemed incorporated in a subsequent deed of conveyance executed by a patentee over land subject of free patent, and he cannot be held to have misrepresented that the land was not subject to repurchase by his failure to mention such right to the purchaser. (Santana vs. Marinas, 94 SCRA 853 [1979].)

**ART. 1317. No one may contract in the name of another without being authorized by the latter, or unless he has by law a right to represent him.**

**A contract entered into in the name of another by one who has no authority or legal representation, or who has acted beyond his powers, shall be unenforceable, unless it is ratified, expressly or impliedly, by the person on whose behalf it has been executed, before it is revoked by the other contracting party. (1259a)**

### Unauthorized contracts are unenforceable.

As a general rule, a person is not bound by the contract of another of which he has no knowledge or to which he has not given his consent. A contract involves the free will of the parties and only he who enters into the contract can be bound thereby. (see Art. 1311, par. 1.) Thus, under Article 1317, a contract entered into in the name of another by one who has no authority is unenforceable[24] against the former unless it is ratified by him before it is revoked by the other contracting party. (see Art. 1403[1].)

An unauthorized contract is not to be confused with a contract for the benefit of a third person. (Art. 1311, par. 2.)

[24]Under the old Civil Code, such unauthorized contract is void.

**Unauthorized contracts can be cured only by ratification.**

The mere lapse of time cannot give efficacy to such a contract. The defect is such that it cannot be cured except by the subsequent ratification (Art. 1405.) of the person in whose name the contract was entered into or by his duly authorized agent and not by any other person not so empowered. (Tipton vs. Velasco, 6 Phil. 67 [1906].) The ratification (see Art. 1392.) must be clear and express so as not to admit of any doubt or vagueness. (Asia Integrated Corp. vs. Alikpala, 72 SCRA 285 [1976].) Its effects retroact to the moment of the celebration of the contract.

It has been ruled that a deed of conveyance executed by the mother who does not appear to have been appointed a judicial guardian of her minor children with the power to sell their property, is unenforceable insofar as the minors are concerned. (Frias vs. Esquivel, 67 SCRA 487 [1975].)

**When a person bound by the contract of another.**

In order that a person may be bound by the contract of another, there are two requisites:

(1) The person entering into the contract must be duly authorized, expressly or impliedly, by the person in whose name he contracts or he must have, by law, a right to represent him (like a guardian or an administrator); and

(2) He must act within his power.

A contract entered into by an agent in excess of his authority is unenforceable against the principal, but the agent is personally liable to the party with whom he contracted where such party was not given sufficient notice of the limits of the powers granted by the principal. (see Art. 1897.)

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# Chapter 2

# ESSENTIAL REQUISITES OF CONTRACTS

## GENERAL PROVISIONS

**ART. 1318. There is no contract unless the following requisites concur:**

**(1) Consent of the contracting parties;**

**(2) Object certain which is the subject matter of the contract;**

**(3) Cause of the obligation which is established. (1261)**

### Classes of elements of a contract.

They are:

(1) *Essential elements* or those without which no contract can validly exist. They are also known as *requisites* of a contract. They may be subdivided into:

(a) *common* or those present in all contracts, namely, consent, object, and cause (Art. 1318.); and

(b) *special* or those not common to all contracts or those which must be present only in or peculiar to certain specified contracts, and such peculiarity may be:

1) as regards to *form,* as for example, public instrument in donation of immovable property (Art. 749.), delivery in real contracts (Art. 1316.), registration in real estate mortgage[1] (Art. 2125.) and chattel mortgage (Art. 2140.), etc.; or

[1]If the instrument in which a real estate mortgage appears is not recorded in the Registry of Property, it is nevertheless binding between the parties. (Art. 2125.)

2) as regards the *subject-matter*, as for example, real property in antichresis (Art. 2132.), personal property in pledge (Art. 2094.), etc.; or

3) as regards the *consideration* or *cause*, as for example, price in sale (Art. 1458.) and in lease (Arts. 1643, 1644.), liberality in commodatum (Art. 1935.), etc. (see G. Florendo, The Law of Obligations and Contracts [1936], p. 561.);

(2) *Natural elements* or those that are presumed to exist in certain contracts unless the contrary is expressly stipulated by the parties, like warranty against eviction (Art. 1548.) or warranty against hidden defects in sale (Art. 1561.); and

(3) *Accidental elements* or the particular stipulations, clauses, terms, or conditions established by the parties in their contract (Art. 1306.), for the purpose of clarifying, restricting, or modifying its legal effects, like conditions, period, interest, penalty, etc., and, therefore, they exist only when they are expressly provided by the parties.

The *good faith* of a party in entering into a contract is immaterial in determining whether it is valid or not — good faith not being an essential element of contract, has no bearing on its validity. (Ballesteros vs. Abios, 482 SCRA 23 [2006].)

**Two bases of contracts.**

The above classification is better understood by keeping in mind the distinction of the influence of two bases of contracts, *viz*., the law and the will.

In descending order, the law imposes the *essential* elements upon the parties; presumes the *natural;* and authorizes the *accidental.* And conversely, the will of the contracting parties yields or conforms to, or respects, the *essential;* accepts, unless it rejects, the *natural;* and creates or establishes the *accidental.* The law is decisive in the first, supplementary in the second, and permissive in the third. (see G. Florendo, *op. cit.*, p. 561, citing 4 Sanchez Roman 183-187; 8 Manresa 664, 665; 3 Giorgi 47, 48.)

Absent one of the essential requisites, no contract can arise. The non-observance of the natural or accidental elements may affect the effectivity but not the validity of the contract. (see Heirs of P. Escanlar vs. Court of Appeals, 281 SCRA 176 [1997].)

**Conflicts rule on essential validity of contracts.**

No conflicts rule on essential validity of contracts is expressly provided for in our laws. The rule followed by most legal systems, however, is that the intrinsic validity of a contract must be governed by the *lex contractus* or "proper law of the contract." This is the law voluntarily agreed upon by the parties.

Philippine courts would do well to adopt the first and most basic rule in most legal systems, namely, to allow the parties to select the law applicable to their contract, subject to the limitation that it is not against the law, morals, or public policy of the forum and that the chosen law must bear a substantive relationship to the transaction. (Phil. Export and Foreign Loan Guarantee Corp. vs. V.P. Eusebio Construction, Inc., 434 SCRA 202 [2004], citing E.L. Paras, Conflict of Laws, p. 414 [6th ed., 1984] and J.R. Salonga, Private International Law, 350 [1995] ed.)

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# SECTION 1. — *Consent*

**ART. 1319. Consent is manifested by the meeting of the offer and the acceptance upon the thing and the cause which are to constitute the contract. The offer must be certain and the acceptance absolute. A qualified acceptance constitutes a counter-offer.**

**Acceptance made by letter or telegram does not bind the offerer except from the time it came to his knowledge. The contract, in such a case, is presumed to have been entered into in the place where the offer was made. (1262a)**

## Meaning of consent.

*Consent* is the conformity of wills and with respect to contracts, it is the agreement of the will of one contracting party with that of another or others, upon the object and terms of the contract. (4 Sanchez Roman 191; 8 Manresa 648.)

## Concurrence of offer and acceptance.

It is the meeting of minds, *i.e.,* the concurrence of offer and acceptance between the parties which expresses their intent in entering into the contract respecting the subject matter and the cause or consideration thereof. (see Yuiengco vs. Dacuycuy, 104 SCRA 668 [1981]; Philippine National Bank vs. Court of Appeals, 262 SCRA 464 [1996]; Insular Life Assurance Co. vs. Assets Builders Corporation, 422 SCRA 148 [2004]; Navarra vs. Planters Development Bank, 527 SCRA 562 [2007].) even if neither has been delivered and notwithstanding that they have not affixed their signatures to its written form.[1] Whether there is a meeting of minds on the offer and acceptance depends on the circumstances surrounding the case.

[1]Consensual contracts are perfected by mere consent (Art. 1315.); in real contracts, there must be delivery. (Art. 1316.) The rule in Article 1319 (first sentence) does not apply to a situation where one or both parties consider that certain matters or details in addition to the subject matter and the consideration, should be agreed upon. The area of agreement must extend to all the points that the parties deem material, or there is no consent at all. (Tan vs. Planters Products, Inc., 550 SCRA 287 [2008].)

The minds of the parties must meet as to all the terms and nothing is left open for further arrangement. Similarly, contract changes must be made with the assent or consent of the contracting parties. If this assent or consent is wanting on the part of one who contracts, his act has no more efficacy than if it had been done under duress or by a person of unsound mind. (Phil. National Bank vs. Court of Appeals, 238 SCRA 20 [1994]; Luxuria Homes, Inc. vs. Court of Appeals, 302 SCRA 315 [1999].)

### Meaning of offer.

*Offer* is a proposal made by one party (offerer) to another to enter into a contract. It is more than an expression of desire or hope. It is really a promise to act or to refrain from acting on condition that the terms thereof are accepted by the person (offeree) to whom it is made.

### Offer must be certain.

The offer must be certain or definite and clear, and not vague or speculative so that the liability (or the rights) of the parties may be exactly fixed because it is necessary that the acceptance be identical with the offer to create a contract without any further act on the part of the offeror.

EXAMPLES:

(1) "Will you buy this watch for P1,000.00?" This is an offer.

(2) "I am willing to consider the sale of my land to you for P100,000.00." The offer here is uncertain. Its acceptance will not create a contract.

(3) "I am willing to buy your car." There is also no offer because it is incomplete. No price is given.

(4) "I am willing to sell my car for P210,000.00 cash or for 12 monthly installments of P20,000.00." The offer is certain; here, the determination of the manner of payment is left to the offeree.

ILLUSTRATIVE CASES:

1. *Offer to sell allows more than one payment of the price but does not state the amount of the first payment.*

*Facts:* S offered to sell his property to B for P1,000,000.00 cash. If its amount could not be paid in cash, the balance was to be paid within a

period not exceeding three years. B accepted the offer, tendering the sum of P100,000.00 as first payment.

*Issue:* Was there acceptance by B?

*Held:* None. The acceptance of B involved a proposal which in turn required acceptance on the part of S. In the offer, a part of the price was to be paid in cash but the amount of the first payment was not determined. *(Zayco vs. Serra, 44 Phil. 326 [1923].)*

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2. *Meaning of phrase "willing to entertain the purchase."*

*Facts:* B wrote S a letter, which began as follows: "In connection with the yacht *Bronzewing,* I am in position and am willing to entertain the purchase of it under the following terms: . . ." To this letter, S affixed his signature at the bottom thereof just below that of B as follows: "Proposition accepted (Sgd.) S."

In a case which arose between B and S, judgment was rendered holding that there was a contract of sale valid and binding upon B. B appealed.

*Issue:* Is the letter a definite offer by B to purchase the yacht such that, by its acceptance, B may be compelled to purchase the yacht?

*Held:* No. Hence, its acceptance did not create a binding contract of sale. B instead of using the expression *"I want to purchase," "I offer to purchase, I am in position to purchase,"* or other similar language of easy and unequivocal meaning, used this other, *"I am in position and am willing to entertain."*

The word *entertain* applied to an act does not mean the resolution to perform said act, but simply a position to deliberate for deciding to perform or not to perform said act. Taking into account only the literal and technical meaning of the word *"entertain,"* the letter of B cannot be interpreted as a definite offer to purchase, but simply a position to deliberate whether or not he would purchase the yacht. It was but a mere invitation to a proposal being made to him, which might be accepted by him or not. *(Rosenstock vs. Burke, 46 Phil. 217 [1924].)*

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3. *Buyer claims his purchase order containing the item number, part number, and description of articles he wanted to buy did not create a perfected contract of sale.*

*Facts:* Private respondent (defendant) SJ established contract with petitioner (plaintiff) JS & Sons regarding bus spare parts SJ wanted to purchase from Germany. JS & Sons referred the list submitted by SJ to the former's trading partner SH for quotation.

Subsequently, petitioner submitted on December 17, 1981, its formal offer containing the item number, quantity, part number, description, unit price and total to respondent who informed petitioner on December 24, 1981 of his desire to avail of the prices of the parts at that time and enclosed its Purchase Order dated December 14, 1981 containing the item number, part number and description, promising to submit the quantity per unit he wanted to order which he did to the general manager of plaintiff on December 29, 1981.

Petitioner immediately ordered the items needed by respondent from SH which sent petitioner a *pro forma* invoice to be used by respondent in applying for a letter of credit to be opened in favor of SH.

Petitioner reminded respondent twice to open the letter of credit. Later, respondent replied that he did not make any valid Purchase Order and that there was no definite contract between him and petitioner. Demand letters sent to respondent by petitioner's counsel were to no avail.

Consequently, petitioner filed a complaint for recovery of actual or compensatory damages, unearned profits, interest, attorney's fees and costs against private respondent.

In its decision dated June 13, 1988, the trial court ruled in favor of petitioner by ordering private respondent to pay petitioner, among others, actual compensatory damages in the amount of DM 51,917.81, unearned profits in the amount of DM 14,061.07, or their peso equivalent.

Thereafter, private respondent elevated his case before the Court of Appeals. On February 18, 1992, the appellate court reversed the decision of the trial court and dismissed the complaint of petitioner. It ruled that there was no perfection of contract since there was no meeting of the minds as to the price between the last week of December 1981 and the first week of January 1982.

*Issue:* The issue posed for resolution is whether or not a contract of sale has been perfected between the parties.

*Held:* (1) *Consent of both parties have been manifested.* — "We reverse the decision of the Court of Appeals and reinstate the decision of the trial court. x x x The facts presented to us indicate that consent on both sides has been manifested.

The offer by petitioner was manifested on December 17, 1981 when petitioner submitted its proposal containing the item number, quantity, part number, description, the unit price and total to private respondent. On December 24, 1981, private respondent informed petitioner of his desire to avail of the prices of the parts at the time and simultaneously enclosed its Purchase Order No. 0101 dated December 14, 1981. At this

stage, a meeting of the minds between vendor and vendee has occurred, the object of the contract being the spare parts and the consideration, the price stated in petitioner's offer dated December 24, 1981.

Although said purchase order did not contain the quantity he wanted to order, private respondent made good his promise to communicate the same on December 19, 1981. At this juncture, it should be pointed out that private respondent was already in the process of executing the agreement previously reached between the parties."

(2) *Petitioner's offer likewise impliedly accepted by respondent*. — "[At the bottom of the Purchase Order], there appears this statement made by private respondent: 'Note: above P.O. will include a 3% discount. The above will serve as our initial P.O.' This notation on the purchase order was another indication of acceptance on the part of the vendee, for by requesting a 3% discount, he implicitly accepted the price as first offered by the vendor. The immediate acceptance by the vendee of the offer was impelled by the fact that on January 1, 1982, prices would go up, as in fact, the petitioner informed him that there would be a 7% increase effective January 1982.

On the other hand, concurrence by the vendor with the said discount requested by the vendee was manifested when petitioner immediately ordered the items needed by private respondent from Schuback Hamburg which in turn ordered from NDK, a supplier of MAN spare parts in West Germany.

When petitioner forwarded its purchase order to NDK, the price was still pegged at the old one. Thus, the pronouncement of the Court of Appeals that there was no confirmed price on or about the last week of December 1981 and/or the first week of January 1982 was erroneous."

(3) *Date when perfection of contract took place.* — "While we agree with the trial court's conclusion that indeed a perfection of the contract was reached between the parties, we differ as to the exact date when it occurred, for perfection took place, not on December 29, 1981, but rather on December 24, 1981. Although the quantity to be ordered was made determinate only on December 29, 1981, quantity is immaterial in the perfection of a sales contract. What is of importance is the meeting of the minds as to the *object* and *cause*, which from the facts disclosed, show that as of December 24, 1981, these essential elements had already concurred."

(4) *Opening of letter of credit not a suspensive condition to effectivity of contract of sale.* — "On the part of the buyer, the situation reveals that private respondent failed to open an irrevocable letter of credit without recourse in favor of Johannes Schuback of Hamburg, Germany. This omission, however, does not prevent the perfection of the contract

between the parties, for the opening of a letter of credit is not to be deemed a suspensive condition. The facts herein do not show that petitioner reserved title to the goods until private respondent had opened a letter of credit. Petitioner, in the course of its dealings with private respondent, did not incorporate any provision declaring their contract of sale without effect until after the fulfillment of the act of opening a letter of credit.

The opening of a letter of credit in favor of a vendor is only a mode of payment. It is not among the essential requirements of a contract of sale enumerated in Articles 1305 and 1474 of the Civil Code, the absence of any of which will prevent the perfection of the contract from taking place.

To adopt the Court of Appeals' ruling that the contract of sale was dependent on the opening of a letter of credit would be untenable from a pragmatic point of view because private respondent would not be able to avail of the old prices which were open to him only for a limited period of time. This explains why private respondent immediately placed the order with petitioner which, in turn promptly contacted its trading partner in Germany.

As succinctly stated by petitioner, it would have been impossible for respondent to avail of the said old prices since the perfection of the contract would arise much later, or after the end of the year 1981, or when he finally opens the letter of credit." *(Johannes Schuback & Sons Philippine Trading Corporation vs. Court of Appeals, 227 SCRA 717 [1993].)*

*Note:* In *Navarra vs. Planters Development Bank* (527 SCRA 562 [2007].). A letter-offer that merely stated that the "purchase price will based on the redemption value plus accrued interest at the prevailing rate up to the date of the contract," was held ambiguous and indefinite because it failed to specify a definite amount of the purchase price, and furthermore, a stipulated period within which the repurchase price shall be paid.

### Meaning of acceptance.

*Acceptance* is the manifestation by the offeree of his assent to the terms of the offer. Without acceptance, there can be no meeting of the minds between the parties. (Art. 1305.) A mere offer produces no obligation.

### Acceptance of offer must be absolute.

The acceptance of an offer must be absolute, unconditional or unqualified, that is, it must be identical in all respects with that of the offer so as to produce the consent or meeting of the minds necessary to perfect a contract.

(1) If the acceptance is qualified, as when it is subject to a condition (*e.g.,* sale price shall be made by installment), or modifies or varies the terms of the offer, it merely constitutes a counter-offer or a new proposal which, in law, is considered a rejection of the original offer and an attempt by the parties to enter into a contract on a different basis. (Logan vs. Phil. Acetylene Co., 33 Phil. 177 [1916]; see Limketkai Sons Milling, Inc. vs. Court of Appeals, 255 SCRA 626 [1996]; see Traders Royal Bank vs. Cuison Lumber Co., Inc., 588 SCRA 690 [2009].)

(2) Similarly, where the parties did not reach an agreement as to the extent of the lot subject of the proposed sale, the acceptance of the offer to sell was held not sufficient to generate consent as what was accepted was not what was exactly proposed in the offer. (Palattao vs. Court of Appeals, 381 SCRA 681 [2002].)

(3) In a case, the giving by the owner of a building of an advance payment was held as not showing an unqualified acceptance of an offer contained in the first proposal of a contract where an entirely new proposal was submitted subsequently by the contractor. The existence of the second proposal belied the perfection of any contract arising from the first proposal. (Waldon Construction Corp. vs. Cancio, 154 SCRA 618 [1987].)

A qualified acceptance must, in turn, be accepted absolutely in order that there will be a contract.

ILLUSTRATIVE CASES:

1. *Meaning of phrase "willing to accept."*

*Facts:* X offered to exchange his sawmill equipment and spare parts for some used tractors of Y. In a reply letter, Y stated that "we are willing to accept the proposition" and referred X to the Property Department for a possible arrangement.

*Issue:* Was there acceptance by Y?

Held: The phrase "willing to accept" signifies that Y was disposed to accept or was agreeable to the proposition or offer in principle, but that other considerations still remained before a contract of barter was perfected. Surely before definitely agreeing to the barter, Y would want first to examine the equipment offered for exchange, especially since it was secondhand. *(Meads vs. Land Settlement and Development Corp., 98 Phil. 119 [1955].)*

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2. *Acceptance of an offer contemplating payment in cash binds offeree to pay within a certain period.*

*Facts:* S made an offer of sale of a hacienda at its assessed valuation to B, to whom was granted three months within which to make use of his right to purchase the property. Subsequently, B accepted the offer for the price quoted by S binding himself to pay the purchase price on or before a period fixed by him (B), which period, however, was to expire within the abovementioned three months.

B brought action for specific performance.

*Issue:* Did the acceptance by B create a perfected contract between S and B?

*Held:* No. In view of the fact that the time for making payment was not fixed in the offer, the purchase price should be paid "immediately and in cash." The period granted B to purchase the property should not be confused with the period for the payment of the price, had B decided to buy it. B had three (3) months within which to make the purchase; to make the payment he did not have a single day after the date on which the proper deed of sale would have been executed in his favor; he was to pay the price at the very moment the said deed was executed.

B's acceptance was not absolute or unconditional as it deviated from one of the conditions related to the cause of the contract, to wit: the form in which payment should be made. *(Beaumont vs. Prieto, 41 Phil. 670 [1921].)*

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3. *Acceptance is on the same terms prospective buyers will offer.*

*Facts:* S offered to sell his *hacienda* to B for "P100,000.00, Philippine currency in cash" should the latter indicate his acceptance on or before a certain date otherwise S would sell the same to others. B sent a reply stating that "I am very much interested to buy and acquire this Hacienda of yours in the same price, manner, conditions and considerations other buyers will offer."

*Issue:* Is there an acceptance of the offer?

*Held:* None. The reply of B is an indication that he would await the offer of any prospective buyer. *(Mirasol vs. Yusay, 11 SCRA 410 [1964].)*

### When acceptance with request for changes in offer not a counter-offer.

An acceptance of an offer may request certain changes in the terms of the offer and yet may be a binding acceptance. So long as it is clear

that the meaning of the acceptance is positively and equivocally to accept the offer, whether such request is granted or not, a contract is formed.

(1) Thus, a vendor's change in a phrase of the offer to purchase, which does not essentially change the terms of the offer, does not amount to a rejection of the offer and the tender of a counter-offer.

(2) Similarly, where the changes or qualifications in the offer are not material or are mere clarifications of what the parties had previously agreed upon (*e.g.*, insertion of *"per annum"* after the word "interest" where the parties had contemplated a rate of 18% *per annum* since 18% a month or even semi-annually would be highly improbable) cannot be categorized as major alterations of the offer that will prevent a meeting of the minds between the parties. (see Villonco Realty Co. vs. Bormacheco, Inc., 65 SCRA 350 [1975].)

However, when any of the elements of the contract is modified upon acceptance, such alteration amounts to a counter-offer. (ABS-CBN Broadcasting Corp. vs. Court of Appeals, 301 SCRA 572 [1999].)

**Acceptance of complex offers.**

(1) *Two or more contracts.* — There may be a single offer involving two or more contracts, and it will depend upon the connection which may exist between the different contracts or the intent of the person making the offer whether partial acceptance will create a contract. (see 8 Manresa 578.)

EXAMPLE:

Where the contracts are related to one another, such as a contract of loan and a mortgage which will secure it, the acceptance of the loan only will not give rise to a perfected contract.

It would be different where one party offers the lease of a parcel of land and the sale of another, and only the lease is accepted, for in such case the acceptance will give rise to a contract of lease unless the offeror should have made one offer dependent upon the other. *(Ibid.)*

(2) *Single contract covering various things.* — In this case, an analogous distinction must be observed. The perfection where there is only partial acceptance of one or some but not all of the things will also depend upon their relation to one another or the intent of the offeror. As a rule, partial acceptance will not give rise to the perfection of the contract where the things are inter-related in themselves; but it will

give rise to a perfected contract where that relation between the things does not exist, except where, in either case, the intent of the offeror is otherwise. (*Ibid.*, 579.)

EXAMPLE:

Where the offer is the sale of a parcel of land and the house thereon, the acceptance of the offer with respect to the land only will not give rise to a perfected contract.

But if the offer involves things which are not related to one another, such as, for example, shares of stocks and a car of the offerer, partial acceptance will generally create a perfected contract.

ILLUSTRATIVE CASE:

*Acceptance refers to one of several items, each of which was complete in itself, of an offer for the construction of a building.*

*Facts:* RFC advertised an "invitation to bid" for the construction of a reinforced concrete building. The proposal submitted by V consisted of several items, among which are: (1) one for P350,000.00 for the "complete construction of the office building" in question "*including* all electrical installations and all plumbing installations"; (2) another for P300,000.00 for the "complete construction of the office building *only*," *excluding,* therefore, the electrical and plumbing installations; (3) a third one for P18,000.00 for the "electrical installations only," *excluding,* therefore, the building and its plumbing installations; and (4) a fourth item for P12,000.00, for the "plumbing installations *only*," excluding, therefore, the building and its electrical installations."

RFC awarded the contract to V only for the plumbing installations. The other items were awarded to other bidders. V refused to sign the contract, claiming that his offer was for the construction of the building with its plumbing and electrical installations, whereas RFC awarded to him the contract for the plumbing installations only, and, therefore, the award substantially modified the terms of his offer, so that a meeting of minds did not take place inasmuch as such modification was not accepted by him.

*Issue:* Was the contract perfected insofar as the plumbing installations were concerned?

*Held:* Yes. Each of the items was complete in itself and as such, it was distinct, separate and independent from the other items. The award in favor of V implied, therefore, neither a modification of his offer nor a partial acceptance thereof. It was an unqualified acceptance of the fourth item of his bid, which item constituted a complete offer or proposal on

the part of V. The effect of said acceptance was to perfect a contract upon notice of the award to V. *(Valencia vs. Rehabilitation Finance Corp., 103 Phil. 444 [1958].)*

**Acceptance made by letter or telegram.**

With regard to contracts between absent persons, the acceptance may be transmitted by any means which the offerer has authorized the offeree to use.

(1) *Knowledge of the acceptance.* — If transmitted by letter or telegram, the contract is perfected not from the time the letter or telegram is sent but from the time of the offerer's knowledge, actual or constructive, of the acceptance. This is the *theory of cognition or information* which the Civil Code has adopted. (Art. 1319, par. 2.)

An example of constructive knowledge is where the letter or telegram containing the acceptance is received by the offerer who for some reason did not read it but not where he *could not have read it* as when he was absent or physically incapacitated at the time of the receipt of the same. The presumption, however, is that the offerer read the contents thereof or came to know of the acceptance.

(2) *Revocation of offer.* — Before the acceptance is known, the offer can be revoked, it not being necessary, in order for the revocation to have the effect of preventing the perfection of the contract, that it be known by the acceptant. (see Laudico and Harden vs. Arias, 43 Phil. 270 [1922].)

(3) *Revocation of acceptance.* — Similarly, the offeree may revoke the acceptance he has already sent, provided, the revocation reaches the offeror before the latter learns of the acceptance.

In short, both the offer and acceptance may be revoked before the contract is perfected which takes place from the time the acceptance comes to the offerer's knowledge.

ILLUSTRATIVE CASE:

*Offer was withdrawn after letter containing the acceptance was sent but before it was received by the offerer.*

*Facts:* X, on his behalf and that of his co-owners, wrote a letter to Y, giving him an option to lease their building to Z. After some negotiation, no definite agreement was arrived at. Y finally wrote a letter to X advising the latter that all his propositions, as amended and supplemented were accepted.

This letter was received by X at 2:53 P.M. of March 6. On that same day, at 11:25 A.M., X had, in turn, written a letter to Y withdrawing the offer to lease the building. Y brought action to compel the execution of the contract of lease.

*Issue:* Under the facts was a contract perfected between X and Y?

*Held:* No. When X sent his letter of withdrawal to Y, X had not yet received the letter of acceptance, and when it reached him, he had already sent his letter of withdrawal. Before X received notice of the acceptance, X was not yet bound by it and consequently, he had the right to withdraw the offer. There was no meeting of the minds through offer and acceptance, which is the essence of the contract.

While there was an offer, there was no acceptance, and when the latter was made and could have binding effect, the offer was then lacking. Though both the offer and acceptance existed, they did not meet to give birth to a contract. (*Landicho and Harden vs. Arias, supra;* see Francisco vs. GSIS, 7 SCRA 577 [1963]; Enriquez vs. Sun Life Assurance Co., 41 Phil. 269 [1920]; Sambrano vs. Court of Tax Appeals, 101 Phil. 1 [1957].)

**ART. 1320. An acceptance may be express or implied. (n)**

## Form of acceptance of offer.

An express acceptance may be oral or written. An implied acceptance is one that is inferred from act or conduct.

(1) *Acceptance by promise.* — An offer of a promise or an act may be accepted by giving a promise, as where a person offers to deliver to another a certain thing if the latter will pay a certain amount, and the other accepts by promising to so pay according to the conditions of the offer. The promise need not be by words but may be inferred from the acts of the parties, as by one or both acting on it as though it were a completed agreement. (see 13 C.J. 274.)

(2) *Acceptance by act.* — An acceptance of an offer may be by act, as where an offer is made that the offerer will do something else, if the offeree shall do a particular thing. In such a case, performance is the only thing needful to complete the agreement and to create a binding promise. (*Ibid*., 275.)

(a) In a case, the petitioner did not affix her signature to the document evidencing the subject concessionaire agreement. However, she performed the tasks indicated in the said agreement for a period of three (3) years without any complaint or question

which fact was held as showing that she had given her implied acceptance of or consent to the said agreement (Lopez vs. Bodega City, 532 SCRA 56 [2007].)

(b) It has been held that where a person accepts the services of another, whether solicited or not, he has the obligation to pay the reasonable value of the services thus rendered upon the implied contract of lease of service unless it is shown that the service was rendered gratuitously (Perez vs. Pomar, 2 Phil. 682 [1903].) or without any expectation that he would pay for the same. (Aldaba vs. Court of Appeals, 27 SCRA 263 [1969].)

(c) In a case where the creditor writing to his debtor for the settlement of the latter's obligation to him and offering to remit or condone the interest on the same on condition that he would immediately pay the principal thereof, it was held that the promise of the debtor to pay, without actually making the payment such that the creditor had to institute legal proceedings for its collection, was not an acceptance. In other words, the offer to remit the interest could only be accepted by an act of payment by the debtor. (Gamboa vs. Gonzales, 17 Phil. 381 [1910].)

(3) *Acceptance by silence or inaction.* — As a rule, silence cannot be construed as acceptance. The acceptance must be affirmatively and clearly made and evidenced by words or some acts or conduct communicated to the offeror. The exceptions are:

(a) where the parties agree expressly or impliedly, that it shall amount to acceptance;

(b) where specific provisions of law so declare (*e.g.*, Arts. 1670, 1870-1873.); and

(c) where under the circumstances such silence constitutes estoppel. (see Art. 1431.)

One receiving a proposal to change a contract to which he is a party, is not obliged to answer the proposal, and his silence *per se* cannot be construed as an acceptance. (Phil. National Bank vs. Court of Appeals, 238 SCRA 20 [1994]; Mendoza vs. Court of Appeals, 359 SCRA 438 [2001].)

**ART. 1321. The person making the offer may fix the time, place, and manner of acceptance, all of which must be complied with. (n)**

### Matters that may be fixed by the offerer.

The person making the offer may prescribe the time, the place, and the manner of acceptance, all of which must be complied with otherwise the offer shall be deemed terminated. An offer is terminated when it is rejected by the offeree. An acceptance departing from the terms of the offer constitutes a counter-offer. Take note that a counter-offer has the effect of extinguishing the offer. It, in effect, constitutes a new offer which the original offerer may accept or reject.

It has been held that when the offeror has not fixed a period for the offeree to accept the offer, and the offer is made to a person present, the acceptance must be made immediately; hence, the offeree cannot complain that he was not given a reasonable period within which to accept or reject the offer of the offeror. (Malbarosa vs. Court of Appeals, 402 SCRA 168 [2003].)

One who receives a proposal or offer to change or modify a contract is not obliged to answer the same. (Phil. National Bank vs. Court of Appeals, 238 SCRA 29 [1994] and 258 SCRA 549 [1996].)

Articles 1321 to 1326 have been adopted from the American law. (Report of the Code Commission, p. 135.)

**ART. 1322. An offer made through an agent is accepted from the time acceptance is communicated to him. (n)**

### Communication of acceptance to agent.

For a contract to arise, the acceptance must be made known to the offeror. By legal fiction, an agent is considered an extension of the personality of his principal. (Art. 1910, par. 1.) If duly authorized, the act of the agent is, in law, the act of the principal.

Article 1322 applies only if the offer is made through the agent and the acceptance is communicated through him. Hence, there would be no meeting of the minds if the principal himself made the offer and the acceptance is communicated to the agent unless, of course, the latter is authorized to receive the acceptance.

**ART. 1323. An offer becomes ineffective upon the death, civil interdiction, insanity, or insolvency of either party before acceptance is conveyed. (n)**

**When offer becomes ineffective.**

An offer may be withdrawn before it is accepted. After acceptance, the contract is already perfected. (Art. 1319.)

Under Article 1323, even if the offer is not withdrawn, its acceptance will not produce a meeting of the minds in case the offer has already become ineffective because of the death, civil interdiction, insanity, or insolvency of either party before the conveyance of the acceptance to the offeror.

It must be observed that the law refers to "either party." This means that at the time the acceptance is communicated, both parties, offerer and offeree, must be living and capacitated. (see Art. 1327.) The death of either party or his loss of capacity before perfection precludes the formation of a contract.

The above grounds are not exclusive. Thus, failure to comply with the condition of the offer as to the time, place, and the manner of payment (Art. 1321.), the expiration of the period fixed in the offer for acceptance (Art. 1324.), the destruction of the thing due before acceptance (Art. 1262.), rejection of the offer, etc. will also render the offer ineffective and prevent the juridical tie from being formed.

**Communication of electronic data messages or electronic documents.**

(1) *Formation and validity or enforceability of electronic contracts.* — Except as otherwise agreed by the parties, an offer, the acceptance of an offer and such other elements required under existing laws for the formation of contracts may be expressed in, demonstrated and proved by means of electronic data messages or electronic documents and no contract shall be denied validity or enforceability on the sole ground that it is in the form of an electronic data message or electronic document, or that any or all of the elements required under existing laws for the formation of the contracts is expressed demonstrated and proved by means of electronic data messages or electronic documents. (Sec. 16[1], R.A. No. 8792.)[2]

[2]The Electronic Commerce Act (June 14, 2000), "An Act providing for the recognition and use of electronic commercial and non-commercial transactions, penalties for unlawful use thereof, and other purposes." For other provisions, see Comments under Arts. 1358 and 1403.

(2) *Recognition by parties of electronic data message or electronic document.* — As between the originator and the addressee of an electronic data message or electronic document, a declaration of will or other statement shall not be denied legal effect, validity or enforceability solely on the ground that it is in the form of an electronic data message or electronic document. (Sec. 17, *Ibid.*)

(3) *Attribution of electronic data message.* — An electronic data message or electronic document is that of the originator if it was sent by the originator himself.

As between the originator and the addressee, an electronic data message or electronic document is deemed to be that of the originator if it was sent:

(a) by a person who had the authority to act on behalf of the originator with respect to that electronic data message or electronic document; or

(b) by an information system programmed by, or on behalf of the originator to operate automatically.

As between the originator and the addressee, an addressee, under certain conditions, is entitled to regard an electronic data message or electronic document as being that of the originator, and to act on that assumption. (see Sec. 18, *Ibid.*)

(4) *Error on electronic data message or electronic document.* — The addressee is entitled to regard the electronic data message or electronic document received as that which the originator intended to send, and to act on that assumption, unless the addressee knew or should have known, had the addressee exercised reasonable care or used the appropriate procedure:

(a) That the transmission resulted in any error therein or in the electronic data message or electronic document when the electronic data message or electronic document enters the designated information system; or

(b) That electronic data message or electronic document is sent to an information system which is not so designated by the addressee for the purpose. (Sec. 19, *Ibid.*)

(5) *Time of receipt of electronic data message or electronic documents.* — Unless otherwise agreed between the originator and the addressee, the

time of receipt of an electronic data message or electronic document is as follows:

(a) If the addressee has designated an information system for the purpose of receiving electronic data messages or electronic documents, receipt occurs at the time when the electronic data message or electronic document enters the designated information system. If the originator and the addressee are both participants in the designated information system, receipt occurs at the time when the electronic data message or electronic document is retrieved by the addressee.

(b) If the electronic data message or electronic document is sent to an information system of the addressee that is not the designated information system, receipt occurs at the time when the electronic document is retrieved by the addressee.

(c) If the addressee has not designated an information system, receipt occurs when the electronic data message or electronic document enters an information system of the addressee.

These rules apply notwithstanding that the place where the information system is located may be different from the place where the electronic data message or electronic document is deemed to be received. (Sec. 22, *Ibid.*)

(6) *Place of dispatch and receipt of electronic data message or electronic document.* — Unless otherwise agreed between the originator and the addressee, an electronic data message or electronic document is deemed to be dispatched at the place where the originator has its place of business and received at the place where the addressee has its place of business. This rule shall apply even if the originator or addressee had used a laptop or other portable device to transmit or receive his electronic data message or electronic document. This rule shall also apply to determine the tax situs of such transaction. (Sec. 23, *Ibid.*)

"Addressee" refers to a person who is intended by the originator to receive the electronic data message or electronic document, but does not include a person acting as an intermediary with respect to that electronic data message or electronic document. (Sec. 5[a], *Ibid.*)

"Originator" refers to a person by whom, or on whose behalf, the electronic document purports to have been created, generated and/or sent. The term does not include a person acting as an intermediary with respect to that electronic document. (Sec. 5[i], *Ibid.*)

"Electronic data message" refers to information generated, sent, received or stored by electronic, optical or similar means. (Sec. 5[c], *Ibid*.)

"Electronic document"[3] refers to information or the representation of information, data, figures, symbols or other modes of written expression, described or however represented, by which a right is established or an obligation is extinguished, or by which a fact may be proved and affirmed, which is received, recorded, transmitted, stored, processed, retrieved or produced electronically. (Sec. 5[f], *Ibid*.)

"Information and communications system" refers to a system for generating, sending, receiving, storing or otherwise processing electronic data messages or electronic documents and includes the computer system or other similar device by or in which data is recorded or stored and any procedures related to the recording or storage of electronic data message or electronic document. (Sec. 5[d], *Ibid*.)

**ART. 1324. When the offerer has allowed the offeree a certain period to accept, the offer may be withdrawn at any time before acceptance by communicating such withdrawal, except when the option is founded upon a consideration, as something paid or promised. (n)**

## Meaning of contract of option; option period; option money.

(1) *Option contract* is a preparatory contract giving a person for a consideration a certain period and under specified conditions within which to accept the offer of the offerer. It is separate and distinct from the projected main agreement or principal contract itself (subject matter of the option) which the parties may enter into upon the consummation of the option or which will be perfected upon the acceptance of the offer.

*Option* may also refer to the privilege itself given to the offeree to accept an offer within a certain period.

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[3]It includes digitally signed documents and any print-out or output, readable by sight or other means, which accurately reflects the electronic data message or electronic document. For purposes of the Rules on Electronic Evidence (A.M. No. 01-7-01 Supreme Court, July 17, 2000, effective Aug. 1, 2000.), the term "electronic document" may be used interchangeably with "electronic data message." (Sec. 1[h], Rule thereof.)

(2) *Option period* is the period given within which the offeree must decide whether or not to enter into the principal contract.

(3) *Option money* is the money paid or promised to be paid as a distinct consideration for an option contract. It is not to be confused with *earnest money* which is actually a partial payment of the purchase price and is considered as proof of the perfection of the contract. (see Art. 1482.) Thus, earnest money presupposes that there is already a sale (or some other contract) with the buyer bound to pay the balance. The would-be buyer who gives option money is not required to buy. (Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995] and Limson vs. Court of Appeals, 357 SCRA 209 [2001], citing *H. De Leon, Comments and Cases on Sales*, 1986 Rev. Ed., p. 67.)

The consideration need not be monetary; it may consist of other things or undertaking but they must be of value, in view of the onerous nature of the contract of option. (Bible Baptist Church vs. Court of Appeals, 444 SCRA 399 [2004]; Navotas Industrial Corporation vs. Cruz, 469 SCRA 530 [2005].)

**Withdrawal of offer where period for acceptance stipulated.**

When the offerer gives to the offeree a certain period within which to accept the offer, the general rule is that the offer may be withdrawn as a matter of right at any time before acceptance.[4] The exception is when the option is founded upon a separate consideration, as something paid or promised in which case, a contract of option is deemed perfected, and the offer may not be withdrawn before the lapse of the option period; otherwise, it would be a breach of the contract of option and render the optioner-offerer liable for damages.

In other words, the option binds the offerer not to enter into the principal contract with any other person during the period fixed, and, within the period, to enter into such contract with the offeree, if the latter should decide to use the option. However, the optionee-offeree may not sue for specific performance on the proposed contract before it has reached its own stage of perfection. (see Asuncion vs. Court of

[4]The right to withdraw, however, must not be exercised whimsically or arbitrarily; otherwise, it could give rise to a damage claim under Article 19 of the Civil Code. (Asuncion vs. Court of Appeals, 238 SCRA 602 [1994].)

Appeals, 238 SCRA 602 [1994]; Carceller vs. Court of Appeals, 302 SCRA 718 [1999].) Only when the option is exercised, may the contract be perfected. (Cavite Development Bank vs. Lim, 324 SCRA 346 [2000].)

In any case, the offerer may not withdraw his offer after it has been accepted.

EXAMPLES:

X offers to construct the house of Y for a very reasonable price of P500,000.00 giving the latter 10 days within which to make up his mind.

Under Article 1324, X may withdraw the offer even before the lapse of 10-days unless Y has already accepted the offer. After acceptance, withdrawal is not possible as there is no more offer to withdraw.

Even before acceptance, X may not withdraw the offer if the option is covered by a consideration as when Y paid or promised to pay a sum of money to X for giving him the 10-day period. There is here an option contract. After the 10-day period, in the absence of acceptance, the offer becomes ineffective.

ILLUSTRATIVE CASE:

*The contract of lease gives the lessee 30-exclusive option to purchase the leased premises.*

*Facts:* A contract of lease provides.

"That if the lessor should desire to sell the leased premises, the lessee shall be given 30-days exclusive *option* to purchase the same."

In the event, however, that the leased premises is sold to someone other than the lessee, the lessor is bound and obligated, as it hereby binds and obligates itself, to stipulate in the Deed of Sale thereof that the purchaser shall recognize this lease and be bound by all the terms and conditions thereof."

*Issue:* Does the contractual stipulation provide for an option clause or an option contract?

*Held:* No. (1) *Contract grants right of first refusal.* — "It is a contract of a right of first refusal. The rule in this jurisdiction is that the deed of option or the option clause in a contract, in order to be valid and enforceable, must, among other things, indicate the definite price at which the person granting the option, is willing to sell.

(2) *Right integral part of contract of lease.* — "In the instant case, the right of first refusal is an integral part of the contract of lease. The lease is built into the reciprocal obligations of the parties. To rule that such a

contractual stipulation is governed by Article 1324 on withdrawal of the offer or Article 1479 on promise to buy and sell could render ineffectual or "inutile" the provisions on right of first refusal as commonly inserted in leases of real estate. Such stipulation is incorporated into contracts of lease for the benefit of the lessee who wants to be assured that it shall be given the first crack or the first option to buy the leased property at the price which the lessor is willing to accept. It is part and partial of the entire contract of lease."

(3) *Consideration for right included in consideration for lease.* — "The consideration for the lease includes the consideration for the right of first refusal. Thus, the lessee is in effect stating that he consents to lease the leased property and to pay the price agreed upon provided that the lessor also consents that should it sell the property, then, the lessee shall be given the right to match the offered purchase price and buy the property. In a reciprocal contract, the obligation or promise of each party is the consideration for that of the other." *(Equatorial Realty Development, Inc. vs. Mayfair Theater, Inc., 264 SCRA 483 [1996].)*

## Articles 1324 and 1479 compared.

Article 1324 lays down the general rule regarding offer and acceptance. It has been interpreted as modified by the provision of Article 1479[5] of the Civil Code which applies specifically to "a promise to buy or sell."

(1) An unconditional *mutual promise* to buy and sell as long as the object is made determinate and the price is fixed can be obligatory on the parties, and compliance therewith may accordingly be exacted. (Asuncion vs. Court of Appeals, *supra.*) A *unilateral promise* to buy or sell a determinate thing not supported by any consideration distinct from the price for which that thing was intended to be sold by or to the promisee (offeree) does not bind the promissor (offerer), *even if accepted,* and may be withdrawn at any time. (see Southern Sugar & Molasses Co. vs. Atlantic Gulf Pacific & Company, 97 Phil. 249 [1955]; Salame vs. Court of Appeals, 239 SCRA 356 [1994]; see Nool vs. Court of Appeals, 276 SCRA 149 [1997]; Eulogio vs. Apales, 576 SCRA 561 [2009].)

[5]Art. 1479. A promise to buy and sell a determinate thing for a price certain is reciprocally demandable.

An accepted unilateral promise to buy or to sell a determinate thing for a price certain is binding upon the promissor if the promise is supported by a consideration distinct from the price. (1451a)

In other words, in order that the promissor will be bound, his offer (unilateral promise which specifies the thing to be sold and the price to be paid) must be accepted *and* it must be founded upon a consideration distinct and separate from the price. This is what may properly be termed a perfected contract of option which is an independent contract by itself. The optionee (holder of option) has the right, but not the obligation, to buy or sell. Once the option is exercised timely, *i.e.*, the offer is accepted before a breach of the option, a bilateral promise to buy and sell ensues and both parties are then reciprocally bound to comply with their respective undertakings. (Asuncion vs. Court of Appeals, *supra.*) In other words, a perfected contract of option does not result in the perfection or consummation of the sale. Only when the option is exercised may a sale be perfected. (Abalos vs. Macatangay, Jr., 439 SCRA 649 [2004].)

(2) In another case, the rule laid down by the Supreme Court, is that there is no distinction between the two articles, the former applying also to a unilateral promise to buy or sell. In other words, if acceptance is made before withdrawal of the offer, it constitutes a binding contract of sale although the option is given without consideration. (see Sanchez vs. Rigors, 45 SCRA 368 [1972]; also Atkins Kroll and Co. vs. Tek, 102 Phil. 948 [1957].)

(3) In the later case of *Cronico vs. J.M. Tuazon & Co., Inc.* (78 SCRA 33 [1977].), the Supreme Court, however, said: "In order that a unilateral promise may be binding upon the promissor, Article 1479 . . . requires the concurrence of the condition that the promise be supported by a consideration distinct from the price. "Accordingly, the promisee cannot compel the promissor to comply with the promise, unless the former establishes the existence of said distinct consideration. The promisee has the burden of proving such consideration."

(4) In *Rural Bank of Parañaque, Inc. vs. Remolado* (135 SCRA 409 [1985].), a commitment by a bank to resell a property within a specified period, although accepted by the party in whose favor it was made, was considered an option not supported by a consideration distinct from the price and, therefore, not binding upon the promissor, and pursuant to *South Western Sugar* case *(supra.)*, it was held void.

(5) In *Mateo vs. Intermediate Appellate Court* (197 SCRA 323 [1991].), where a bank made the assurance, after the expiration of the redemption period, that the petitioners can redeem the property as

soon as they have the money, the bank was held not bound by the promise because it was not supported by a consideration distinct from the repurchase price. (see Yao Ka Sin Trading vs. Court of Appeals, 209 SCRA 703 [1992].)

(6) In *Vda. de Quirino vs. Palanca* (29 SCRA 1 [1969].), involving a contract of lease with option to buy, it was held that "the [separate] consideration for the lessor's obligation to sell the leased premises to the lessee should he choose to exercise his option to purchase the same, is the obligation of the lessee to sell to the lessor the building and/or improvements constructed and/or made by the former, if he fails to exercise his option to buy said premises."

In *Serra vs. Court of Appeals* (229 SCRA 60 [1994].), the consideration is more onerous on the part of the lessee, *i.e.*, to transfer the building and/or improvements on the property to the lessor should the lessee fail to exercise its option within the period stipulated.

**Option contract and right of first refusal distinguished.**

Contractual obligations arising from right of first refusal are not new in our jurisdiction and have been recognized in numerous cases. (J.G. Summit Holdings, Inc. vs. Court of Appeals, 450 SCRA 169 [2005].)

An option is a preparatory contract in which one party grants to another, for a fixed period and at a determined price, the privilege to buy or sell, or to decide whether or not to enter into a principal contract. It binds the party who has given the option not to enter into the principal contract with any other person during the period designated, and within that period, to enter into such contract with the one to whom the option was granted, if the latter should decide to use the option.

In a right of first refusal, on the other hand, while the object might be made determinate, the exercise of the right would be dependent not only on the grantor's eventual intention to enter into a binding juridical relation with another but also on terms, including the price, that are yet to be firmed up. (Vasquez vs. Ayala Corporation, 443 SCRA 231 [2004].)

The basis of the right of first refusal must be the current offer to sell of the seller or offer of the purchaser to buy. (Tanay Recreation

Center & Dev. Corp. vs. Fausto, 455 SCRA 436 [2005].) *Note:* See Riviera Filipina, Inc. vs. Court of Appeals, 380 SCRA 245 [2002], under Article 1339.

**Option contract and contract of sale distinguished.**

The distinction between an "option" and a contract of sale is that an option is an unaccepted offer. An option contract states the terms and conditions on which the owner is willing to sell his property, if the holder elects to accept them within the time limited. If the holder does so elect, he must give notice to the other party, and the accepted offer thereupon becomes a valid and binding contract. If an acceptance is not made within the time fixed, the owner is no longer bound by his offer, and the option is at an end.

A contract of sale, on the other hand, fixes definitely the relative rights and obligations of both parties at the time of its execution. The offer and the acceptance are concurrent, since the minds of the contracting parties meet in the terms of the agreement.

The test in determining whether a "contract is a contract of sale or purchase" or a mere "option" is whether or not the agreement could be specifically enforced. There is no doubt that the obligation of the purchaser to pay the purchase price is specific, definite and certain and consequently, binding and enforceable. An agreement is only an "option" when no obligation rests on the party to make any payment except such as may be agreed on between the parties as consideration to support the option until he has made up his mind within the time specified. (Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995]; see Limson vs. Court of Appeals, 357 SCRA 209 [2001].) An option merely grants a privilege to buy or sell within an agreed time and at a determined price. (Abalos vs. Macatangay, Jr., 439 SCRA 649 [2004].)

ILLUSTRATIVE CASE:

*The document signed by the parties is entitled, "Exclusive Option to Purchase" but the facts show that the parties intended to enter into a contract to sell.*

*Facts*: An "Exclusive Option to Purchase" was executed between petitioner AP (buyer) and private respondents PR (sellers), under the following terms and conditions:

"1. The selling price of said 8,655 square meters of the subject property is P2,856,150.00;

2. The sum of P50,000.00 which we received from ADELFA PROPERTIES, INC., as an option money shall be credited as partial payment upon the consummation of the sale and the balance in the sum of P2,806,150.00 to be paid on or before November 30, 1989;

3. In case of default on the part of ADELFA PROPERTIES, INC. to pay said balance in accordance with paragraph 2 hereof, this option shall be cancelled and 50% of the option money to be forfeited in our favor and we will refund the remaining 50% of said option money upon the sale of said property to a third party;

4. All expenses including the corresponding capital gains tax, cost of documentary stamps are for the account of the VENDORS, and expenses for the registration of the deed of sale in the Registry of Deeds are for the account of ADELFA PROPERTIES, INC."

PR's counsel turned over to AP the certificate of title to the property. Before AP could make payment, it received summons together with a copy of a complaint filed by the nephews and nieces of PR for the annulment of the deed of sale and recovery of the property. AP suspended payment which act, PR attributed to the former's "lack of word of honor."

*Issue:* One of the issues is whether or not the contract executed between the parties is an option contract, a contract of sale, or a perfected contract to sell.

*Held:* (1) *Option contract as a contract to sell, rather than a contract of sale.* — "The distinction between the two is important for in a contract of sale, the title passes to the vendee upon the delivery of the thing sold; whereas in a contract to sell, by agreement the ownership is reserved in the vendor and is not to pass until the full payment of the price. In a contract of sale, the vendor has lost and cannot recover ownership until and unless the contract is resolved or rescinded; whereas in a contract to sell, title is retained by the vendor until the full payment of the price, such payment being a positive suspensive condition and failure of which is not a breach but an event that prevents the obligation of the vendor to convey title from becoming effective.

Thus, a deed of sale is considered absolute in nature where there is neither a stipulation in the deed that title to the property sold is reserved in the seller until the full payment of the price, nor one giving the vendor the right to unilaterally resolve the contract the moment the buyer fails to pay within a fixed period."

(2) *Parties never intended to transfer ownership.* — "There are two features which convinced us that the parties never intended to transfer ownership to petitioner except upon full payment of the purchase price. Firstly, the exclusive option to purchase, although it provided for automatic rescission of the contract and partial forfeiture of the amount already paid in case of default, does not mention that petitioner is obliged to return possession or ownership of the property as a consequence of non-payment.

There is no stipulation anent reversion or reconveyance of the property to herein private respondent in the event that petitioner does not comply with its obligation. With the absence of such a stipulation, although there is a provision on the remedies available to the parties in case of breach, it may legally be inferred that the parties never intended to transfer ownership to the petitioner prior to completion of payment of the purchase price.

In effect, there was an implied agreement that ownership shall not pass to the purchaser until he had fully paid the price. Article 1478 of the Civil Code does not require that such a stipulation be expressly made. Consequently, an implied stipulation to that effect is considered valid and, therefore, binding and enforceable between the parties. It should be noted that under the law and jurisprudence, *a contract which contains this kind of stipulation is considered a contract to sell.* x x x

Secondly, it has not been shown that there was delivery of the property, actual or constructive, made to herein petitioner. The exclusive option to purchase is not contained in a public instrument the execution of which would have been considered equivalent to delivery. Neither did petitioner take actual, physical possession of the property at any given time.

It is true that after the reconstitution of private respondents' certificate of title, it remained in the possession of petitioner's counsel, Atty. Bayani L. Bernardo, who thereafter delivered the same to herein petitioner. Normally, under the law, such possession by the vendee is to be understood as a delivery. However, private respondent explained that there was really no intention on their part to deliver the title to herein petitioner with the purpose of transferring ownership to it. They claim that Atty. Bernardo had possession of the title only because he was their counsel in the petition for reconstitution.

We have no reason not to believe this explanation of private respondents, aside from the fact that such contention was never refuted or contradicted by petitioner."

(3) *Nature of option.* — "An option, as used in the law on sales, is a continuing offer or contract by which the owner stipulates with another that the latter shall have the right to buy the property at a fixed price within a certain time, or under, or in compliance with, certain terms and conditions, or which gives to the owner of the property the right to sell or demand a sale. It is also sometimes called an 'unaccepted offer.'

An option is not of itself a purchase, but merely secures the privilege to buy. It is not a sale of property but a sale of the right to purchase. It is simply a contract by which the owner of property agrees with another person that he shall have the right to buy his property at a fixed price within a certain time. He does not sell his land; he does not then agree to sell it; but he does sell something, that is, the right or privilege to buy at the election or option of the other party.

Its distinguishing characteristic is that it imposes no binding obligation on the person holding the option, aside from the consideration for the offer. Until acceptance, it is not, properly speaking, a contract, and does not vest, transfer, or agree to transfer, any title to, or any interest or right in the subject matter, but it is merely a contract by which the owner of property gives the optionee the right or privilege of accepting the offer and buying the property on certain terms."

(4) *Contract to sell perfected.* — "A perusal of the contract in this case, as well as the oral and documentary evidence presented by the parties, readily shows that there is indeed a concurrence of petitioner's offer to buy and private respondents' acceptance thereof. The rule is that except where a formal acceptance is so required, although the acceptance must be affirmatively and clearly made and must be evidenced by some acts or conduct communicated to the offeror, it may be made either on a formal or an informal manner, and may be shown by acts, conduct, or words of the accepting party that clearly manifest a present intention or determination to accept the offer to buy or sell. Thus, acceptance may be shown by the acts, conduct, or words of a party recognizing the existence of the contract of sale.

The records also show that private respondents accepted the offer of petitioner to buy their property under the terms of their contract. x x x

The agreement as to the object, the price of the property, and the terms of payment was clear and well-defined. No other significance could be given to such acts than that they were meant to finalize and perfect the transaction. The parties even went beyond the basic requirements of the law by stipulating that 'all expenses including the corresponding capital gains tax, cost of documentary stamps are for the account of the vendors, and expenses for the registration of the deed of sale in the

Registry of Deeds are for the account of Adelfa Properties, Inc.' Hence, there was nothing left to be done except the performance of the respective obligations of the parties."

(5) *Obligation of AP to pay balance of purchase price.* — "x x x The failure of the petitioner to pay the balance of the purchase price within the agreed period was attributed by private respondents to 'lack of word of honor' on the part of the former. The reason of 'lack of word of honor' is to us a clear indication that private respondents considered petitioner already bound by its obligation to pay the balance of the consideration. In effect, private respondents were demanding or exacting fulfillment of the obligation from herein petitioner. With the arrival of the period agreed upon by the parties, petitioner was supposed to comply with the obligation incumbent upon it to perform, not merely to exercise an option or a right to buy the property.

The obligation of petitioner on November 30, 1993 consisted of an obligation to give something, that is, the payment of the purchase price. The contract did not simply give petitioner the discretion to pay for the property. It will be noted that there is nothing in the said contract to show that petitioner was merely given a certain period within which to exercise its privilege to buy. The agreed period was intended to give time to herein petitioner within which to fulfill and comply with its obligation, that is, to pay the balance of the purchase price. No evidence was presented by private respondents to prove otherwise. x x x

This is not a case where no right is as yet created nor an obligation declared, as where something further remains to be done before the buyer and seller obligate themselves. An agreement is only an 'option' when no obligation rests on the party to make any payment except such as may be agreed on between the parties as consideration to support the option until he has made up his mind within the time specified. An option, and not a contract to purchase, is effected by an agreement to sell real estate for payments to be made within a specified time and providing for forfeiture of money paid upon failure to make payment, where the purchaser does not agree to purchase, to make payment, or to bind himself in any way other than the forfeiture of the payments made. As hereinbefore discussed, this is not the situation obtaining in the case at bar.

While there is jurisprudence to the effect that a contract which provides that the initial payment shall be totally forfeited in case of default in payment is to be considered as an option contract, still we are not inclined to conform with the findings of respondent court and the court *a quo* that the contract executed between the parties is an option

contract, for the reason that the parties were already contemplating the *payment of the balance of the purchase price,* and were not merely quoting an agreed value for the property. The term 'balance,' connotes a remainder or something remaining from the original total sum already agreed upon."

(6) *Alleged option money actually intended as earnest money.* — "In other words, the alleged option money of P50,000.00 was actually earnest money which was intended to form part of the purchase price. The amount of P50,000.00 was not distinct from the cause or consideration for the sale of the property, but was itself a part thereof. It is a statutory rule that whenever earnest money is given in a contract of sale, it shall be considered as part of the price and as proof of the perfection of the contract. It constitutes an advance payment and must, therefore, be deducted from the total price. Also, earnest money is given by the buyer to the seller to bind the bargain.

There are clear distinctions between earnest money and option money, *viz.*: (a) earnest money is part of the purchase price, while option money is the money given as a distinct consideration for an option contract; (b) earnest money is given only where there is already a sale, while option money applies to a sale not yet perfected; and (c) when earnest money is given, the buyer is bound to pay the balance, while when the would-be buyer gives option money, he is not required to buy. *(De Leon, Comments and Cases on Sales, 1986 Rev. Ed., 67.)*

The aforequoted characteristics of earnest money are apparent in the so-called option contract under review, even though it was called "option money" by the parties. In addition, private respondents failed to show that the payment of the balance of the purchase price was only a condition precedent to the acceptance of the offer or to the exercise of the right to buy. On the contrary, it has been sufficiently established that such payment was but an element of the performance of petitioner's obligation under the contract to sell." *(Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995].)*

**ART. 1325. Unless it appears otherwise, business advertisements of things for sale are not definite offers, but mere invitations to make an offer. (n)**

## Business advertisements generally not definite offers.

Business advertisements of things for sale are not definite offers, acceptance of which will perfect a contract but are merely invitations to the reader to make an offer or only as proposals. However, if the

advertisement is complete in all the particulars necessary in a contract, it may amount to a definite offer which, if accepted, will produce a perfected contract.

EXAMPLES:

(1) "For sale: 1,000 square meters lot at Green Plains Village, Quezon City for P5,000,000.00 — Tel. No. 817-12-84." This is not a definite offer.

(2) "For sale: 1,000 square meters lot at Green Plains Village, Quezon City located at the corner of Geronimo and Magallanes Streets for P5,000,000.00 cash. — Tel. No. 817-12-84." This is a definite offer.

**Acceptance of general or public offers.**

As a general rule, an offer is made to a particular person. Consequently, only such person, and no other, can accept the offer. This is because "a party has a right to select and determine with whom he will contract, and cannot have another person thrust upon him without his consent." (Boston & Co. vs. Potter, 123 Mass. 28.)

There are, however, exceptions to this general rule, the most common of which concern the so-called "general offer." The principle is that a general offer made to the public, or to a particular class of persons, may be accepted by any one or by any one coming within the description of the class, as for example, an offer of a prize for a design for a public building or a bonus to any one who will make a certain improvement, or of a reward, and other like cases. Such offers, although made to an unascertained person or persons, cannot, of course, be turned into an agreement until they have been accepted by an ascertained person. As soon as there is an acceptance by a person falling within the class to whom the offer is made, there is a binding contract. (see 13 C.J. 273-274.)

"It is an elementary principle that where a party publishes an offer to the world, and before it is withdrawn another acts upon it, the party making the offer is bound to perform his promise. This principle is frequently applied in cases of the offer of rewards." (6 R.C.L. 607, cited in De la Rosa vs. Bank of the Phil. Islands, 51 Phil. 926 [1928].) But the acceptance must be in strict conformity with the offer and a qualified acceptance does not create a contract. (Montinola vs. Victoria Milling Co. and Copper, 54 Phil. 782 [1930].)

**ART. 1326. Advertisements for bidders are simply invitations to make proposals, and the advertiser is not bound to accept the highest or lowest bidder, unless the contrary appears. (n)**

**Advertisements for bidders generally not definite offers.**

(1) *Acceptance of bid.* — In an advertisement for bidders, the advertiser is not the one making the offer. In reality, the bidder is the one making the offer which the advertiser is free to accept or reject.

(a) Acceptance by the advertiser of a given bid is necessary for a contract to exist between the advertiser and the bidder, regardless of the terms and conditions of his bid. (Surigao Mineral Reservation Board vs. Cloribel, 24 SCRA 898 [1968].) Where under the rules of the bidding it is only upon receipt of the notice of acceptance of the bid that the formal contract shall be executed, in the absence of such notice and execution of the contract, there is no meeting of the minds. (Santamaria vs. Court of Appeals, 187 SCRA 186 [1990].)

(b) As a general rule, the advertiser is not bound to accept the highest bidder (as when the offer is to buy) or the lowest bidder (as when the offer is to construct a building) unless the contrary appears. In judicial sales, however, the sheriff or auctioneer is bound to accept the highest bid. (see Rule 39, Sec. 19, Rules of Court.) Where a seller reserved the right to refuse to accept the bid made, a binding sale is not perfected until the seller accepts the bid. The seller may exercise his right to reject any bid after the auctioneer has accepted a bid. (Caugma vs. People, 486 SCRA 611 [2006].)

(2) *Compliance with terms of bid.* — (a) One who submits a bid not only signifies assent to the terms and conditions of a proposal, but impliedly binds himself to them, if and when the bid is considered. (Insular Life Assn. Co., Ltd. vs. Asset Builders Corp., 422 SCRA 148 [2004].)

The owner of the property which is advertised for sale, either at public or private auction, has the right to prescribe the manner, conditions and terms of the sale and anybody participating in such sale is bound by all the conditions, whether he knew them or not. (Leoquinco vs. Postal Savings Bank, 47 Phil. 772 [1925]; Borromeo

vs. City of Manila, 62 Phil. 512 [1935].) Even a government-owned corporation, after acceptance of a bid, in the absence of justifiable reasons, cannot simply refuse to execute the contract and thereby avoid it to the prejudice of the other party under the guise of protecting the public interest; otherwise, the door would be wide open to abuses and anomalies more detrimental to public interest. (Central Bank vs. Court of Appeals, 63 SCRA 431 [1975].)

In the case, however, of the Subic Bay Metropolitan Authority (SBMA), a chartered institution directly under the Office of the President, the revocation by the President of the award to the winning bidder previously declared by the SBMA Board of Directors was upheld. "The President may, within his authority, overturn or reverse any award made by the SBMA Board of Directors for justifiable reasons. It is well-established that the discretion to accept or reject any bid, or even recall the award thereof, is of such wide latitude that the courts will not generally interfere with the exercise thereof by the executive department, unless it is apparent that such exercise of discretion is used to shield unfairness or unjustice." (Hutchison Ports Philippines Limited vs. Subic Bay Metropolitan Authority, 339 SCRA 434 [2000]; see Desierto vs. Ocampo, 452 SCRA 789 [2005].)

**Reservation of right to reject any or all bid in public biddings.**

A reservation in the advertisement for bids of the right of the government to reject any bid, generally vests in the authorities a wide discretion as to who is the best and most advantageous bidder. This involves inquiry, investigation, comparison, deliberation and decision, which are quasi-judicial functions and, when honestly exercised, may not be reviewed by the courts. In such cases, there is no binding obligation to award the contract to any bidder and in the exercise of such discretion, the award may be made validly to whoever among the participating bidders has submitted the most advantageous bid. (Virata vs. Bocar, 50 SCRA 468 [1973]; National Power Corporation vs. Philipp Brothers Oceanic, Inc., 369 SCRA 629 [2001]; see Public Estates Authority vs. Bolinao Security and Investigation Services, Inc., 472 SCRA 165 [2005]; Albay Accredited Contractors Assoc., Inc. vs. Desierto, 480 SCRA 520 [2006]; Urbanes, Jr. vs. Local Water Utilities Administration, 500 SCRA 52 [2006]; First United Constructors Corp. vs. Poro Point Management Corp., 576 SCRA 311 [2009].)

Unless an unfairness or injustice is shown, after the Government has made its choice, the losing bidder has no cause to complain, nor right to dispute that choice.[6] (Mata vs. San Diego, 63 SCRA 170 [1975].) But a contract granted without the competitive bidding required by law is void. The three (3) principles of a public bidding are the offer to the public, an opportunity for competition, and a basis for exact comparison of bids. (Oani vs. People, 454 SCRA 416 [2005].)

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[6]The word "bidding," in its comprehensive sense, means making an offer or an invitation to prospective contractors whereby the government manifests its intention to make proposals for the purchase of supplies, materials and equipment for official business or public use, or for public works or repair. The three principles in public bidding are: the offer to the public; an opportunity for competition; and a basis for exact comparison of bids. In the public bidding for public contracts, the award is generally given to the lowest bidder while in the disposition of government assets, the award is to the biggest bidder. The term "public bidding" imports a sale to the highest bidder with absolute freedom for competitive bidding.

Under Section 504 of the Government Auditing Rules and Regulations, a public auction, which is the mode of divestment or disposal of government property, shall adhere to established mechanics and procedures in public bidding. In such public auction sales, the presence of a Commission on Audit (COA) representative who shall see to the proper observance of auditing rules is imperative. In this case, there is no record that a COA representative witnessed the public auction on December 2, 1993. Neither is there is showing that the Asset Privatization Trust (APT) observed the requirement of COA Circular No. 89-296, to the effect that a government entity that is disposing of government property shall furnish the COA with the disposal procedure adopted. Likewise, nowhere in the record is it stated that the APT heeded the suggestion of Secretary of Finance and COP Chairman Jayme that its decision to grant Kawasaki the right to top the highest bid be made "known to the Commission on Audit." What appears on record is that the COA did not approve the Asset Specific Bidding Rules (ASBR), specifically the provision on the right to top "the highest bidder. (JG Summit Holdings, Inc. vs. Court of Appeals, 345 SCRA 143 [2000].)" As long as the principles are complied with, the public bidding can be considered valid and legal. It is not necessary that the highest bid be automatically accepted. The bidding rules may specify other conditions or the bidding process be subjected to certain reservation or qualification. Under the ASBR, the Government expressly reserved the right to reject any or all bids, and manifested its intention not to accept the highest bid should Kawasaki decide to exercise its right to top under the ASBR which right was made known to all the bidders. The evidence of the right did not destroy the essence of competitive bidding. Public bidding is the accepted method in arriving at a fair and reasonable price and ensures that overpricing, favoritism and other anomalous practices are eliminated or minimized. But the requirement for public bidding does not negate the exercise of the right of first refusal. In fact, public bidding is an essential first step in the exercise of the right of first refusal because it is only after the public bidding that the terms upon which the Government may be said to be willing to sell its shares to third parties may be known. It is only after the public bidding that the Government will have a basis with which to offer Kawasaki the option to buy or forego the shares." (*Ibid*., 412 SCRA 10 [2003]; see MIAA vs. Olongapo Maintenance Services, Inc., 543 SCRA 269 [2008]). Motion for reconsideration granted.) The Commission on Audit does not require public bidding of *publicly listed shares of stock* as the stock market determines the price of the shares; hence, by analogy, the stock market itself can be considered as public bidding. (Pacific Basin Securities Co., Inc. vs. Oriental Petroleum and Minerals Corp., 531 SCRA 667 [2007].)

**ART. 1327. The following cannot give consent to a contract:**

**(1) Unemancipated minors;**

**(2) Insane or demented persons, and deaf-mutes who do not know how to write. (1263a)**

## Capacity and incapacity classified and distinguished.

To form a valid and legal agreement, it is necessary that there be a party capable of contracting and a party capable of being contracted with. (Heirs of Ingjug-Tiro vs. Spouses Casals, 363 SCRA 435 [2001].) The capacity of persons, whether natural or artificial (associations, partnerships, corporations, etc.), to give consent may be classified into:

(1) *Natural capacity.* — Only natural persons have natural capacity, but in order that they may have full capacity to contract, they must not only have the natural capacity to contract, but also the legal capacity. The absence of natural capacity results in natural incapacity, the causes of which are based on nature or real absence of aptitude to consent, as in the case of an insane; and

(2) *Legal capacity.* — It refers not only to natural persons, but also to artificial as well. The absence of legal capacity results in legal incapacity, the causes of which are based on positive provisions of law, and exist in opposition to, or as limitations of, natural capacity, as in the case of persons under civil interdiction.

Legal incapacities are primarily based (a) on the existence of superior rights of third persons, like the incapacity of the insolvent; and sometimes (b) on the ground of public policy, or for the protection of public interest, as in the case of the incapacity of certain specially disqualified persons enumerated in Article 1491[7] to purchase certain

[7]Art. 1491. The following persons cannot acquire by purchase, even at a public or judicial auction, either in person or through the mediation of another:

(1) The guardian, the property of the person or persons who may be under his guardianship;

(2) Agents, the property whose administration or sale may have been entrusted to them, unless the consent of the principal has been given;

(3) Executors and administrators, the property of the estate under administration;

(4) Public officers and employees, the property of the State or of any subdivision thereof, or of any government-owned or -controlled corporation, or institution, the administration of which has been intrusted to them; this provision shall apply to judges and government experts who, in any manner whatsoever take part in the sale;

kinds of property. (G. Florendo, The Law of Obligations and Contracts [1936], p. 597, citing 3 Giorgi 49-53 and 8 Manresa 638-639.) A person is not incapacitated to contract merely because of advanced years or by reason of physical infirmities. (Loyola vs. Court of Appeals, 326 SCRA 285 [2000].)

**Capacity to give consent presumed.**

The Civil Code does not define who have capacity. It defines on the contrary who have no capacity, by which it can be inferred that capacity is the general rule, which exists in those of whom the law has not denied it. (8 Manresa 658; see the Standard Oil Co. vs. Arenas, 19 Phil. 363 [1911].) A person is not incapacitated to contract merely because of advanced years or by reason of physical infirmities, unless such age and infirmities impair his mental faculties to the extent that he is unable to properly intelligently and fairly understand the provisions of the contract. (Loyola vs. Court of Appeals, 326 SCRA 285 [2000]; Domingo vs. Court of Appeals, 367 SCRA 368 [2001]; Yason vs. Arciaga, 449 SCRA 458 [2005].)

Capacity shown to have previously existed in other acts done or contracts entered into is presumed to continue. The burden of proof is on the party who asserts incapacity.

**Persons who cannot give consent.**

There is no effective consent in law without the capacity to give such capacity. (Felix Gochan vs. Heirs of R. Baba, 409 SCRA 306 [2003].)

A contract entered into where one of the parties is incapable of giving consent to a contract is voidable. A voidable contract is valid and binding until it is annulled by a proper action in court. It is susceptible of ratification. (Art. 1390.) If both parties are incapable of giving consent, the contract is unenforceable unless they are ratified. (Art. 1403[3].)

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(5) Justices, judges, prosecuting attorneys, clerks of superior and inferior courts, and other officers and employees connected with the administration of justice, the property and rights in litigation or levied upon an execution before the court within whose jurisdiction or territory they exercise their respective functions; this prohibition includes the act of acquiring by assignment and shall apply to lawyers, with respect to the property and rights which may be the object of any litigation in which they may take part by virtue of their profession;

(6) Any others specially disqualified by law. (1459a)

Those who are incapacitated to give consent under Article 1327 are the following:

(1) *Unemancipated minors.* — They refer to those persons who have not yet reached the age of majority (18 years) and are still subject to parental authority. A minor can be emancipated by attainment of the age of majority, by marriage, or by the recording in the Civil Register of an agreement in a public document executed by the parent exercising parental authority and the minor at least 18 years of age. (Art. 234, Family Code.)

(a) The Supreme Court has held that the sale of real estate, effected by minors who have already passed the age of puberty and adolescence and are near the adult age when they pretended to have already reached their majority, when in fact they have not, is valid; and they cannot be permitted afterwards to excuse themselves from compliance with obligations assumed by them or to seek their annulment.

The judgment that holds said a sale to be valid does not violate the laws relative to the sale of minor's property. This doctrine is entirely in accord with the provisions of Section 3(a), Rule 131 of the Rules of Court, which determine cases of estoppel. (Mercado and Mercado vs. Espiritu, 37 Phil. 215 [1917]; Suan Chiao vs. Alcantara, 85 Phil. 669 [1950].)

(b) The above doctrine must be understood as limited to cases wherein, on account of the minor's representations as to his majority, and because of his near approach thereto, the other party had good reason to believe and did in fact believe the minor capable of contracting. (Justice Carson, concurring in Mercado vs. Espiritu, *supra*.)

It is not applicable where the vendor, a minor, did not pretend to be of age, and his minority was known to the purchaser (Bambalan vs. Maramba, 51 Phil. 457 [1928].), and there is authority for the view that in the absence of false representations by a minor as to his age, the mere fact that the person with whom he dealt believed him to be of age even though his belief was warranted by the minor's appearance and the surrounding circumstances, and the minor knew of such belief, will not render the contract valid or estop the minor to disaffirm. (22 Cyc. 610, cited by Justice Carson.)

(c) It has been held, however, by the Court of Appeals that a misrepresentation made by a minor as to his age does not estop him from denying that he was of age at the time he entered into a contract on the reasoning that a minor who cannot bind himself by a contract should not be bound by any misrepresentation he may have made in connection therewith. (Young vs. Tecson, [C.A.] 39 O.G. 953.) "If he could not bound by a direct act, such as the execution of a deed of sale, how could he be bound by an indirect act, such as his misrepresentation as to his age." (Justice Padilla, dissenting in Suan Chiao vs. Alcantara, *supra*.)

(2) *Insane or demented persons.* — The insanity must exist at the time of contracting. Unless proved otherwise, a person is presumed to be of sound mind at any particular time and the condition is presumed to continue to exist. (Mendezona vs. Ozamiz, 376 SCRA 482 [2002]; Torres de Bueno vs. Lopez, 48 Phil. 772 [1926].) Thus, the mere fact that the vendor was judicially declared mentally incapacitated nine (9) days after the execution of the deed of sale does not prove conclusively that he was incapacitated when the contract was executed, and in the absence of sufficient proof that he was suffering from mental alienation at the specified time, the declaration does not warrant the annulment of said contract. (Carillo vs. Jaojoco, 46 Phil. 957 [1924].)

(3) *Deaf-mutes.* — They are persons who are deaf and dumb. However, if the deaf-mute knows how to write, the contract is valid for then he is capable of giving intelligent consent. A person who does not know how to write, does not know how to read: and one who knows how to read necessarily knows how to write. A contract entered into by a deaf-mute who knows how to read is, therefore, valid, although he cannot write because of some physical reasons.

### Reason for disqualification.

The reason behind Article 1327 is that those persons mentioned can easily be the victims of fraud as they are not capable of understanding or knowing the nature or import of their actions. They can enter into a contract only through a parent or guardian.

**ART. 1328. Contracts entered into during a lucid interval are valid. Contracts agreed to in a state of drunkenness or during a hypnotic spell are voidable. (n)**

### Contracts entered into during a lucid interval.

*Lucid interval* is a temporary period of sanity. A contract entered into by an insane or demented person during a lucid interval is valid. It must be shown, however, that there is a full return of the mind to sanity as to enable him to understand the contract he is entering into.

A contract entered into by a person under guardianship for insanity will be upheld, provided, it is shown that at the time of entering into said contract, he was not insane, or that his mental defect, if mentally deranged, did not interfere with or affect his capacity to appreciate the meaning and significance of the transaction entered into by him. As to such person, his insanity must be presumed to continue at the moment of contracting, but such presumption is *prima facie* and may be rebutted. (see Dumaguin vs. Reynolds, 92 Phil. 66 [1952].)

### Effect of drunkenness and hypnotic spell.

Drunkenness and hypnotic spell impair the capacity of a person to give intelligent consent. (8 Manresa 660-661.)

These conditions are equivalent to temporary insanity. Hence, the law considers a contract entered into in a state of drunkenness or during a hypnotic spell voidable, and it is not required that such state was procured by the circumvention of the other party.

**ART. 1329. The incapacity declared in Article 1327 is subject to the modifications determined by law, and is understood to be without prejudice to special disqualifications established in the laws. (1264)**

### Incapacity declared in Article 1327 subject to modifications.

In general, the contracts entered into by the persons enumerated in Article 1327 are voidable. (Art. 1390.) However, in certain cases, their incapacity may be modified by law, that is, they can also give valid consent. Thus:

(1) When necessaries such as food, are sold and delivered to a minor or other person without capacity to act, he must pay a reasonable price therefor. (Art. 1489; see also Art. 194, Family Code.)

(2) A minor, 18 years old or above may contract for life, health and accident insurance, provided, the insurance is taken on his life

and the beneficiary appointed is the minor's estate or the minor's father, mother, spouse, brother, or sister. (Insurance Code of 1978 [Pres. Decree No. 1460], Sec. 3, par. 3.)

(3) A contract is valid if entered into through a guardian or legal representative. (see Art. 1381[1, 2].)

(4) A contract is valid where the minor who was near majority age misrepresented his actual age and convincingly led the other party to believe in his legal capacity. (Mercado vs. Espiritu, 37 Phil. 215 [1917], *supra*.)

(5) A contract is valid where a minor between 18 and 21 years of age[8] voluntarily pays a sum of money or delivers a fungible thing in fulfillment of his obligation thereunder and the obligee has spent or consumed it in good faith. (Art. 1427.)

(6) Emancipation of a minor for any cause such as by marriage or by recorded agreement, shall terminate parental authority over his person and property and he shall then be qualified and responsible for all acts of civil life. (Arts. 234, 236, Family Code.) The parents may entrust the management or administration of any of their properties to an unemancipated child. (Art. 227, *Ibid*.)

ILLUSTRATIVE CASE:

*A debtor invokes the minority of his co-debtor as a defense to release him from liability; liability of minors for loans contracted by them.*

*Facts:* X and her two sons, Y and Z, who were then 16 and 18 years, respectively, borrowed from C P70,000.00 in Japanese military notes. They executed a note promising solidarily to pay C P10,000.00 "in legal currency of the Philippines, two (2) years after the cessation of present hostilities," plus 2% interest *per annum*. In an action by C to recover the loan, Y and Z interposed the defense of minority.

*Issue:* (1) What is the effect of the minority of the co-signers Y and Z on the liability of X?

(2) Can Y and Z be held legally bound by their signatures in the note?

*Held:* (1) The minority of Y and Z does not release X from liability, since it is a personal defense of the minors. However, X can avail herself of the defense but such defense will benefit her only as regards that

[8]Under Art. 234 of the Family Code, as amended by R.A. No. 6809, "unless otherwise provided, majority commences at the age of 18 years."

part of the debt for which the minors are responsible. (see Art. 1222.) Therefore, he shall pay 1/3 of P10,000.00 plus 2% interest from October, 1944, the date of the loan.

(2) No. The *Mercado* case *(supra.)* is different because the document signed therein by the minors specifically stated that they were of age. In other words, in the *Mercado* case, the minors were guilty of active misrepresentation; whereas in this case, the minors are guilty of passive or constructive misrepresentation. There silence in making a contract as to one's age does not constitute a fraud which can be made the basis of an action for deceit. *In order to hold a minor liable, the fraud must be actual and not constructive.* Therefore, Y and Z cannot be legally bound by their signatures in the promissory note.

It appears, however, that the funds were used for their support during the Japanese occupation. Such being the case, it is but fair to hold that they had profited to the extent of the value of such money, which value has been established by the Ballantyne Schedule and that they should make restitution to that extent. (Art. 1399.) In October, 1944, P40 Japanese military notes were equivalent to P1.00 of current Philippine money. (see Art. 1249.) Hence, Y and Z shall pay jointly P1,666.67, plus 6% interest beginning March 7, 1949, when the complaint was filed. *(Braganza vs. Villa Abrile, 105 Phil. 456 [1959].)*

### Other special disqualifications may be provided by law.

In addition to the incapacity declared in Article 1327, other special disqualifications may be provided by law.

(1) Under the Rules of Court, the following are considered incompetents and may be placed under guardianship:

(a) persons suffering the accessory penalty of civil interdiction (see Art. 34, Revised Penal Code.);

(b) hospitalized lepers;

(c) prodigals (spendthrifts);

(d) deaf and dumb who are unable to read and write;

(e) those who are of unsound mind even though they have lucid intervals; and

(f) those who, by reason of age, disease, weak mind and other similar causes, cannot without outside aid, take care of themselves and manage their property, becoming thereby an easy prey for deceit and exploitation. (Sec. 2, Rule 92, Rules of Court.)

A contract entered into by any of the above is valid except where it is voidable by reason of incapacity under Articles 1327 and 1328 or of causes which vitiate consent (Art. 1330.), or where the incompetent has been placed under guardianship. Thus, a prodigal is presumed to have capacity to enter into a contract.

(2) The following, among others, cannot also give valid consent:

(a) insolvents until discharged (Insolvency Law [Act No. 1956, as amended.], Sec. 1.);

(b) married women in cases specified by law (see Art. 39.[9]);

(c) husband and wife with respect to sale of property to each other (Art. 1490.[10]) or donation of property to each other (Art. 87,[11] Family Code.), or donation of any community or conjugal partnership property to a third person without the consent of the other. (Arts. 98, 125,[12] *Ibid*.)

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[9]Art. 39. The following circumstances, among others, modify or limit capacity to act: age, insanity, imbecility, the state of being a deaf-mute, penalty, prodigality, family relations, alienage, absence, insolvency and trusteeship. The consequences of these circumstances are governed in this Code, other codes, the Rules of Court, and in specials laws. Capacity to act is not limited on account of religious belief or political opinion.

A married woman, twenty-one years of age or over, is qualified for all acts of civil life, except in cases specified by law. (n)

[10]Art. 1490. The husband and the wife cannot sell property to each other, except:

(1) When a separation of property was agreed upon in the marriage settlements; or

(2) When there has been a judicial separation of property under Article 191. (1458a)

Art. 191. The husband or the wife may ask for the separation of property, and it shall be decreed when the spouse of the petitioner has been sentenced to a penalty which carries with it civil interdiction, or has been declared absent, or when legal separation has been granted. x x x.

*Under the Family Code:* "Art. 128. If a spouse without just cause abandons the other or fails to comply with his or her obligations to the family, the aggrieved spouse may petition the court for receivership, for judicial separation of property, or for authority to be the sole administrator of the conjugal partnership property, subject to such precautionary conditions as the court may impose. x x x."

A similar provision in the Family Code is Article 101 with respect to absolute community property.

[11]Art. 87. Every donation or grant of gratuitous advantage, direct or indirect, between the spouses during the marriage shall be void, except moderate gifts which the spouses may give each other on the occasion of any family rejoicing. The prohibition shall also apply to persons living together as husband and wife without a valid marriage. (133a)

[12]Art. 98. Neither spouse may donate any community property without the consent of the other. However, either spouse may, without the consent of the other, make moderate donations from the community property for charity or on occasions of family rejoicing or family distress. (n)

Art. 125. Neither spouse may donate any conjugal partnership property without the consent of the other. However, either spouse may, without the consent of the other, make mod-

(d) other persons especially disqualified by law. (see Arts. 1491,[13] 1789.[14])

Where the disqualification to contract amounts to a prohibition to contract on grounds of public policy such as the prohibition with respect to husband and wife (see Note 3.), public officials and employees, judges and lawyers (see Note 6.), are void in accordance with Article 1409(2) and Article 5[15] of the Civil Code.

**Effect of weakness of mind.**

Weakness of mind alone, not caused by insanity, is not a ground for avoiding a contract. It is only when there is "great weakness of mind in a person executing a conveyance of land arising from age, sickness or any other cause" can a person ask a court of equity to interfere in order to set aside the conveyance.

(1) In a case, although at the time of the sale the vendor was already of advanced age (83 years old), yet it was ruled that he was still physically fit and his mind was keen and clear as shown by the several letters and documents signed and executed by him many months after the execution of the deed of sale in question. (Cui vs. Cui, 100 Phil. 913 [1957].)

(2) The fact that the vendor was 82 years, sick and bedridden when she affixed her thumbmark to the contract of sale was held not a ground for vacating the contract where the respondents failed to prove that she was physically and mentally incapable of entering into the contract. It is of no moment that persons merely affixed his thumbmark on the document even though he was able to read and write, if the deed is in all respects a valid one. (Yason vs. Arciaga, 449 SCRA 458 [2005].)

(3) Where, however, the seller was already 100 years old, very ill and could not talk when his thumbmark was affixed to a notarized deed

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erate donations from the conjugal partnership property for charity or on occasions of family rejoicing or family distress. (174a)

[13]See Note 1 to Art. 1327.

[14]Art. 1789. An industrial partner cannot engage in business for himself, unless the partnership expressly permits him to do so; and if he should do so, the capitalist partners may either exclude him from the firm or avail themselves of the benefits which he may have obtained in violation of this provision, with a right to damages in either case. (n)

[15]Art. 5. Acts executed against the provisions of mandatory or prohibitory laws shall be void, except when the law itself authorizes their validity. (4a)

of sale of a parcel of land with an area of 18 hectares and an assessed value of P4,300 for only P700.00, the deed was held void and inexistent for lack of consent. (Javier vs. Cruz, 80 SCRA 343 [1977].) The general rule is that a person is not incompetent to contract merely because of advanced years or by reason of physical infirmities. However, when such age or infirmities have impaired the mental faculties as to prevent the person from properly, intelligently and firmly protecting his property rights, then he is undeniably incapacitated. (Domingo vs. Court of Appeals, 367 SCRA 368 [2001]; Paragas vs. Heirs of D. Balecano, 468 SCRA 717 [2005]; Landicho vs. Sia, 576 SCRA 602 [2009].)

**ART. 1330. A contract where consent is given through mistake, violence, intimidation, undue influence, or fraud is voidable. (1265a)**

### Characteristics of consent.

In order that consent may be sufficient for purposes of contract, it is required, not only that it exists. Aside from the requirement that consent must be manifested by the meeting of the offer and the acceptance (Art. 1319.), there is no valid consent unless:

(1) *It is intelligent.* — There is legal capacity to act. (see Arts. 1327-1329.) The consent must be given with an exact notion over the thing consented to or the matter to which it refers. In the case of a juridical persons such as a corporation, consent may only be given through officers duly authorized by its board of directors;

(2) *It is free and voluntary.* — There is no vitiation of consent by reason of violence or intimidation (see Art. 1330.); and

(3) *It is conscious or spontaneous.* — There is no vitiation of consent by reason of mistake, undue influence, or fraud.

Thus, Article 1330 enumerates in a negative manner the different requisites of consent. In addition, under Articles 1327, 1328, and 1329, the contracting parties must possess the necessary legal capacity. (Arts. 1327-1329.) Simulation of contract renders the apparent contract void. (see Arts. 1345-1346.)

### Vices of consent.

Aside from incapacity and simulation of contract, the following are the causes that vitiate consent or render it defective so as to make the contract voidable:

(1) error or mistake (Art. 1331.);

(2) violence or force (Art. 1335.);

(3) intimidation or threat or duress *(Ibid.);*

(4) undue influence (Art. 1337.); and

(5) fraud or deceit. (Art. 1338.)

These vices are defects of the will, the existence of which impairs the intelligence (1), freedom (2, 3, 4) and spontaneity (5) of the party in giving consent to the contract. Courts are given wide latitude in weighing the facts and circumstances in a given case, considering the age, physical infirmity, intelligence, relationship, and the conduct of the parties at the time of making the contract and subsequent thereto, irrespective of whether the contract is in a public or private writing. (Leonardo vs. Court of Appeals, 438 SCRA 201 [2004]; Lim, Jr. vs. San, 438 SCRA 102 [2004]; Vda. De Ape vs. Court of Appeals, 456 SCRA 193 [2005].)

### Causes vitiating consent and causes of incapacity distinguished.

(1) The former are temporary, while the latter are more or less permanent; and

(2) The first refer to the contract itself, while the second, to the person entering into the contract.

Both make a contract voidable or annullable only (see Art. 1390[2].), not void.[16]

### Consent reluctantly given.

(1) *In general.* — A distinction must be made between a case where a person gives his consent reluctantly and even against his good sense and judgment and where he, in reality, gives no consent at all, as where he executes a contract or performs an act against his will under a pressure which he cannot resist. It is clear that one acts as voluntarily and independently in the eyes of the law when he acts *reluctantly* and with hesitation as when he acts spontaneously and joyously.

Legally speaking, one acts voluntarily and freely when he acts wholly against his better sense and judgment as when he acts in

[16]See note under Article 1390.

conformity with them. Between the two acts, there is no difference in law. (Vales vs. Villa, 35 Phil. 789 [1916]; Acasio vs. Corporacion de las PP. Dominicos, 100 Phil. 523 [1956]; Reyes vs. Zaballero, 89 Phil. 39 [1951].) Thus:

(2) *Reparation made by reason of a threatened civil or criminal action.* — A contract whereby reparation is made by one party for injuries which he has willfully inflicted upon another or for that which he had misappropriated or misapplied is one which from its inherent nature is entered into reluctantly and against the strong desires of the party making the reparation. He is confronted with a situation in which he finds the necessity either of making reparation or of taking the consequences, civil or criminal, of his unlawful acts. He makes the contract of reparation with extreme reluctance and only by the compelling force of the punishment threatened. Nevertheless, such contract is binding and enforceable. (Martinez vs. Hongkong & Shanghai Bank, 15 Phil. 252 [1910].)

(3) *Payment made to secure extinction from a disadvantageous contract.* — "The failure to reduce a contract to writing, or to have witnesses when a verbal agreement is made, or to record an instrument, or to exclude from the operation of its terms things verbally agreed to be excluded, etc., may place a person in a disadvantageous position with respect to another; and the demand that he pay to secure his extrication is not illegal, and a payment made pursuant to such demand is not necessarily voidable. He pays for his lack of foresight. While the demand may be reprehensible morally, it is not illegal, and of itself is not ground for relief." (Vales vs. Villa, *supra.*)

(4) *Contract signed to avoid unfavorable publicity and court action.* — A Licensing Agreement whereby petitioner bound himself to pay the deceased's family certain amounts for the showing of a movie entitled "The Moises Padilla Story" produced by the petitioner was held valid against the contention that petitioner was pressured into signing the Agreement because of private respondent's demand for payment for the "exploitation" of the life story of Moises Padilla, otherwise, she would "call a press conference declaring the whole picture as a fake, fraud and a hoax and would denounce the whole thing in the press radio, and television and that they were going to court to stop the picture."

It is necessary to distinguish between real duress and the motive which is present when one gives his consent reluctantly. A contract is valid even though one of the parties entered into it against his own wishes and desires or even against his better judgment. In legal effect, there is no difference between a contract wherein one of the contracting parties exchanges one condition for another because he looks for greater profit or gain by reason of such exchange, and an agreement wherein one of the contracting parties agrees to accept the lesser of two disadvantages. In either case, he makes a choice free and untrammelled and must accordingly abide by it. (Lagunsad vs. Soto Vda. de Gonzales, 92 SCRA 476 [1979].)

(5) *Contract of adhesion.* — Generally, the terms of a contract result from the material formulation thereof by the parties thereto. It is, however, of common knowledge that there are certain contracts almost all the provisions of which have been drafted by only one party, usually a corporation (*e.g.,* insurance company). Such contracts are called contracts of adhesion because the only participation of the party is the affixing of his signature or his "adhesion" thereto. (see Art. 1377.)

In situations when a party imposes upon another a ready made form of contract and the other is reduced to the alternative of taking it or leaving it, giving no reason for negotiation and depriving the latter of the opportunity to bargain on equal footing, a contract of adhesion results. While such contract is not necessarily void, it must nevertheless be construed strictly against the one who drafted the same. (Geraldez vs. Court of Appeals, 230 SCRA 320 [1994]; see Art. 1377.)

**ART. 1331. In order that mistake may invalidate consent, it should refer to the substance of the thing which is the object of the contract, or to those conditions which have principally moved one or both parties to enter into the contract.**

**Mistake as to the identity or qualifications of one of the parties will vitiate consent only when such identity or qualifications have been the principal cause of the contract.**

**A simple mistake of account shall give rise to its correction. (1266a)**

## Meaning of mistake or error.

*Mistake* or *error* is the false notion of a thing or a fact material to the contract.

**Nature of mistake.**

(1) Mistake may be of fact or of law. In general (see Art. 1334.), the mistake to which Article 1331 refers is *mistake of fact.* It may arise from ignorance or lack of knowledge.

(2) The mistake contemplated by law is *substantial mistake of fact,* that is, the party would not have given his consent had he known of the mistake. Hence, not every mistake will vitiate consent and make a contract voidable.

**Mistake of fact to which law refers.**

In order that mistake may vitiate consent, it must refer to:

(1) the substance of the thing which is the object of the contract; or

(2) those conditions which have principally moved one or both parties to enter into the contract; or

(3) the identity or qualifications of one of the parties, provided, the same was the principal cause of the contract.

No. 1 above includes mistake regarding the *nature of the contract,* as when the contracting parties believe that the other is selling, when in truth and in fact, both are buying. (see Madrigal & Co. vs. Stevenson & Co., 15 Phil. 38 [1910].)

**Mistake of fact which does not vitiate consent.**

(1) Error as regards the *incidents* of a thing or accidental qualities thereof (*e.g.,* accessibility of a residential house to means of transportation; maximum speed of a car), not taken as the principal consideration of the contract, does not vitiate consent (Art. 1331, par. 1.), unless the error is caused by fraud of the other party. (see Art. 1338.)

(2) Mistake as to *quantity* or *amount* does not also vitiate consent but only gives rise to its correction (*Ibid.,* par. 3.), unless it goes to the essence of the contract.

(3) Error as regards the *motives* of the contract (see Art. 1351.) does not also vitiate consent unless the motives constitute a condition or cause of the contract.

(4) Mistake as regards the *identity* or *qualifications* of a party does not vitiate consent for the reason that contracts are entered into more

in consideration of the things or services which form their subject matter rather than of persons. The exception is when such identity or qualifications have been the principal cause of the contract (Art. 1331, par. 2.), as in contracts, which have for their object obligations to do, requiring personal qualifications of the debtor, or involving trust and confidence, such as contracts of partnership, agency, commodatum, guaranty deposit, etc.

(5) Error *which could have been avoided* by the party alleging it, or which refers to a fact known to him, or which he should have known by the exercise of ordinary diligence, or which is so patent and obvious that nobody could have made it, will not invalidate consent. (Alcasid vs. Court of Appeals, 237 SCRA 419 [1994]; see Domingo Realty, Inc. vs. Court of Appeals, 513 SCRA 40 [2007].)

EXAMPLES:

(1) *Mistake regarding object.* —

(a) B is buying from S a breeding cow but S is selling a barren cow.

(b) B is buying from S a particular cow but by mistake it is substituted by another cow.

(2) *Mistake regarding condition of the contract.* — S is selling his parcel of land for P100,000.00 cash but B is buying the land thinking that the price is payable in installments.

(3) *Mistake regarding identity or qualifications.* —

(a) S sold his car to B. S thought that B, who is a lawyer, was a doctor. The mistake here is not material as to avoid the contract.

(b) R donated his car to E. R thought that E was his half-brother. It turned out that E is not related to R. The mistake as to the identity of E in this case is material because his identity was the principal reason or consideration for the donation.

(4) *Mistake which could have been avoided.* — S was willing to sell her share of two parcels of land, provided, that her co-owners would also sell their respective shares of the said land. S engaged the services of lawyer L without knowing that L was also representing B, the prospective buyer. L confirmed to S that all her co-owners were amenable to sell their shares. After S signed the deed of sale, drafted by L, he learned that the other co-owners did not agree to sell their shares over the subject property.

S cannot invoke mistake in order to annul the sale because he could have avoided the alleged mistake had she exerted efforts to verify from her co-owners if they really consented to sell their respective shares. (Alcasid vs. Court of Appeals, 237 SCRA 419 [1994].)

ILLUSTRATIVE CASES:

1. *Area of land sold for a lump sum is bigger than that shown in the subdivision plan.*

*Facts:* S sold to B several hectares of land for a lump sum. (see Art. 1542.) After the sale, a new survey was made which showed that the area was not 1,023 hectares as shown in S's subdivision plan but 1,091.24 hectares.

*Issue:* Is S entitled to recover the difference?

*Held:* No. If S entered to sell by the meter (see Art. 1539.), he should have so stated in the contract. The excess in area cannot operate to change the contract. The error, the possibility of which neither party could have ignored, was a hazard which they must be presumed to have assumed. The hazard was not one-sided but worked both ways.

Contracts solemnly and deliberately entered into may not be overturned by inconclusive proof or by reason of mistakes of one of the parties to which the other in no way has contributed. The law abhors lawsuits, and litigations would be fostered if contracts were to be overturned on slight or uncertain evidence. The only way in which such litigations could be minimized if not entirely prevented is by holding the parties conclusively bound by the terms of their agreement as expressed in writing, unless the contrary is shown by clear proof. *(Vda. de Gonzales Mondragon vs. Santos, 87 Phil. 471 [1950].)*

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2. *Meaning of phrase "more or less" when used in a contract of sale.*

*Facts:* S thought he was selling and B thought he was buying a tract of land containing 25 hectares more or less with its corresponding crop estimated at 2,000 piculs of sugar. In reality, the land contained only a little more than 18 hectares and produced a crop of only about 800 piculs.

*Issue:* May the contract be rescinded on the ground of mutual mistake?

*Held:* Yes. Mutual mistake of the contracting parties to a sale in regard to the subject matter thereof which is so material as to go to the essence of the contract is a ground for relief and rescission. Without the mistake as to the quantity of the land sold and as to the amount of the standing crop, the agreement would not have been made.

The use of the phrase "more or less" in designating quantity covers only a reasonable excess or deficiency. Such words may indeed relieve from exactness but not from gross deficiency. Specific performance of the contract could not, therefore, be allowed at the instance of S, the vendor. *(Asiain vs. Jalandoni, 45 Phil. 296 [1923].)*

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3. *Mortgagor allegedly committed a mistake in entering into a contract for himself and not in the name of another.*

*Facts:* X brought action against S to annul a mortgage in which it appears that he (X), in order to secure the payment of two promissory notes, mortgaged a machine, on the ground that he committed a mistake in entering into contract for himself and not in the name of B, the real buyer. It was not proven that B had taken any part or had any interest in the purchase of said machine.

*Issue:* Will the action of X prosper?

*Held:* No. It is a general principle of law that no one may be permitted to disavow and go back upon his acts, or to proceed contrary thereto. If, after a perfect and binding contract has been executed between the parties, it occurs to one of them to allege some defect therein as a reason for annulling it, the alleged defect must be conclusively proven since the validity and fulfillment of contracts cannot be left to the will of one of the contracting parties. (Art. 1308.)

In order that an action to secure the annulment of a contract on account of error alleged to have been committed in its execution may prosper, it is indispensable that the case shall fall within the conditions prescribed in Article 1331. *(Joaquin vs. Mitsumine, 34 Phil. 858 [1916].)*

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4. *A mistake traceable to an erroneous survey was made in the deed of sale the identification of the parcel of land intended to be sold.*

*Facts:* Private respondent CD Corporation is the owner of three (3) parcels of land. Adjacent to parcel No. 3 is a vacant lot denominated as parcel No. 4 which is not owned by CDC.

CDC constructed a two-storey house on parcel No. 3. However, in a survey conducted, parcel No. 3 was erroneously indicated to be covered by TCT No. 15515, while the two (2) titled lands (parcels Nos. 1 and 2) were mistakenly surveyed to be located on parcel No. 4 instead. Unaware of the mistake by which CDC appeared to be the owner of parcel No. 43, CDC sold said parcel No. 4 to petitioner spouses.

To remedy the mistake, CDC offered parcel Nos. 1 and 2 as these two were precisely the two vacant lots which it owned and intended to sell to petitioners who insisted on taking parcel No. 3 upon which a two-

storey house stands, in addition to parcel No. 2. CDC this time offered the return of an amount double the price paid by petitioners who insisted on their stand.

CDC was then compelled to file an action for annulment of the deed of sale and reconveyance of the properties subject thereof.

*Issue:* Is the contract of sale voidable on the ground of mistake?

*Held:* Yes. (1) *CDC committed an honest mistake.* — "In the case at bar, the private respondent obviously committed an honest mistake in selling parcel No. 4. As correctly noted by the Court of Appeals, it is quite impossible for said private respondent to sell the lot in question as the same is not owned by it. The good faith of the private respondent is evident in the fact that when the mistake was discovered, it immediately offered two other vacant lots to the petitioners or to reimburse them with twice the amount paid.

That petitioners refused either option left the private respondent with no other choice but to file an action for the annulment of the deed of sale on the ground of mistake."

(2) *Concept of error in Article 1331.* — "Article 1331 of the New Civil Code provides for the situations whereby mistake may invalidate consent. Tolentino (Civil Code of the Phils., p. 476, Vol. 4, 1991 Ed.) explains that the concept of error in this article must include both ignorance, which is the absence of knowledge with respect to a thing, and mistake properly speaking, which is a wrong conception about said thing, or a belief in the existence of some circumstance, fact, or event, which in reality does not exist. In both cases, there is a lack of full and correct knowledge about the thing.

The mistake committed by the private respondent in selling parcel No. 4 to the petitioners falls within the second type. Verily, such mistake invalidated its consent and as such, annulment of the deed of sale is proper."

(3) *Parcel No. 3 cannot be given to petitioner in lieu of parcel No. 4.* — "The petitioners cannot be justified in their insistence that parcel No. 3, upon which private respondent constructed a two-storey house, be given to them in lieu of parcel No. 4. The cost of construction in 1985 for the said house (P1,500,000.00) far exceeds the amount paid by the petitioners to the private respondent (P486,000.00). Moreover, the trial court, in questioning private respondent's witness (who is also its authorized representative), clarified that parcel No. 4, the lot mistakenly sold, was a vacant lot.

Thus, to allow the petitioners to take parcel No. 3 would be to countenance unjust enrichment. Considering that petitioners intended at the

outset to purchase a vacant lot, their refusal to accept the offer of the private respondent to give them two (2) other vacant lots in exchange, as well as their insistence on parcel No. 3, which is a house and lot, is manifestly unreasonable." *(Theis vs. Court of Appeals, 268 SCRA 167 [1997].)*

**Effect of simple mistake of account.**

A simple mistake of account or calculation does not avoid a contract because it does not affect its essential requisites. The defect is merely in the computation of the account or amount which can be corrected.

It has been held that revision of accounts after they have been approved by the one whom they affect may be demanded only by the latter in the cases in which the law so permits for justifiable reasons, and such revision will not be permitted unless the plaintiff can show that there was fraud, deceit, error or mistake in the approval of the accounts. (Gonzales vs. Harty and Hartigan, 32 Phil. 328 [1915]; see Aldecoa & Co. vs. Warner, Barnes & Co., 16 Phil. 423 [1910]; Gutierrez Hermanos vs. Oria Hermanos & Co., 30 Phil. 491 [1915]; Oquiñena & Co. vs. Muertegui, 32 Phil. 261 [1915].)

**ART. 1332. When one of the parties is unable to read, or if the contract is in a language not understood by him, and mistake or fraud is alleged, the person enforcing the contract must show that the terms thereof have been fully explained to the former. (n)**

**Burden of proof in case of mistake or fraud.**

When a person signs a document, the presumption is that he does so with full knowledge of its contents and consequences. Should he later on allege fraud or mistake, it is incumbent upon him to prove his allegation since it is presumed that a person takes ordinary care of his concerns and that private contracts have been fair and regular. This rule is especially applied with aspect to notarial documents which are clothed with the presumption of regularity and due execution. (Rules of Court, Rule 132[B], Sec. 30.)

Article 1332 is an exception to this rule. When one of the parties is unable to read or if the contract is in a language not understood by him, it is the party enforcing the contract who is duty bound to show that there has been no fraud or mistake and that the terms of the contract

have been fully explained to the former in a language understood by him. If he fails to discharge this burden, the presumption of mistake or fraud stands unrebutted. (see Mayor vs. Belen, 430 SCRA 561 [2004]; Feliciano vs. Zaldivar, 503 SCRA 182 [2006].)

"This rule is especially necessary in the Philippines where unfortunately there is still a fairly large number of illiterates, and where documents are usually drawn up in English or Spanish." (Report of the Code Commission, p. 136.) It is also in accord with the State policy of promoting social justice (Constitution, Art. II, Sec. 10.) It also supplements Article 24 of the Civil Code which calls on the courts to be vigilant in the protection of the rights of those who are disadvantaged in life. (Lim vs. Court of Appeals, 229 SCRA 616 [1994]; see Tan vs. Mandap, 429 SCRA 711 [2004]; Vda. de Ape vs. Court of Appeals, 456 SCRA 193 [2005].)

For the proper application of Article 1332, it has first to be established convincingly that the illiterate or the party at a disadvantage due to his mental weakness, ignorance or other handicap could not read or that the contract was written in a language not understood by him. (Bunyi vs. Reyes, 39 SCRA 504 [1971]; see Hemedes vs. Court of Appeals, 316 SCRA 347 [1999]; Arriola vs. Mahilum, 337 SCRA 464 [2000]; Katipunan vs. Katipunan, Jr., 375 SCRA 200 [2002].) Only after sufficient proof of such fact, may the burden of proving that the terms of the contract had been explained to the disadvantaged party be shifted to the party enforcing the contract. (Sales vs. Court of Appeals, 211 SCRA 858 [1992]; see Cayabyab vs. Intermediate Appellate Court, 232 SCRA 1 [1994]; Dela Cruz vs. Dela Cruz, 419 SCRA 648 [2004].)

The duty imposed by Article 1332 does not apply to a party who is not seeking to enforce the contract. The provision contemplates a situation where the consent of one contracting party was given but vitiated by mistake or fraud by the other; it is not applicable where there is a complete absence of consent.

ILLUSTRATIVE CASE:

*Insurer refused to pay beneficiary on the ground of concealment by insured whom the beneficiary claimed was illiterate.*

*Facts:* W, a Chinese widow and illiterate obtained a life insurance policy. In her application, which was in the English language, she gave answers which indicated that she was healthy, which, however, was not the case. The insurer refused to pay B, the beneficiary on the ground of concealment.

B brought action for the enforcement of the policy. It is the position of B, that because W was illiterate and spoke only Chinese, she could not be held guilty of concealment of her health history because the application for insurance was in English and the insurer has not proved that the terms thereof had been fully explained to her.

*Issue:* Is Article 1332 applicable?

*Held:* No. Here, the insurer is not seeking to enforce the contract; on the contrary, it is seeking to avoid its performance. It is B who is seeking to enforce it even as fraud or mistake is not alleged. Accordingly, the insurance company was under no obligation to prove that the terms of the insurance contract were fully explained to the other party. Even if it could be said that the insurer is the one seeking the performance of the contract by avoiding payment of the claim, there has been no imputation of fraud or mistake by the illiterate insured. *(Tang vs. Court of Appeals, 90 SCRA 236 [1979].)*

*Antonio, J., concurring:* "Certainly, petitioner [B] cannot assume inconsistent positions by attempting to enforce the contract of insurance for the purpose of collecting the proceeds of the policy and at the same time nullify the contract by claiming that [the insured] executed the same thru fraud or mistake."

### Duty of courts where one of contracting parties at a disadvantage.

Article 1332 is in full accord with the policy expressly embodied in our civil law which enjoins courts to be more vigilant for the protection of a contracting party who occupies an inferior position with respect to the other contracting party. (see KLM Royal Dutch Airlines vs. Court of Appeals, 65 SCRA 237 [1975].)

In Article 24 under "Human Relations" of the Civil Code, it is provided that "in all contractual, property or other relations, when one of the parties is at a disadvantage on account of his moral dependence, ignorance, indigence, mental weakness, tender age or other handicap, the courts must be vigilant for his protection." This provision expressly enjoins the protection by the courts of the disadvantaged in order to insure that justice and fair play characterize the relationship of the contracting parties. (Sweet Lines, Inc. vs. Teves, 83 SCRA 361 [1978]; see Art. 1337.)

**ART. 1333. There is no mistake if the party alleging it knew the doubt, contingency or risk affecting the object of the contract. (n)**

### Effect of knowledge of risk.

If a party knew beforehand the doubt, contingency, or risk; affecting the object of the contract, it is to be assumed that he was willing to take chances and cannot, therefore, claim mistake. (see Martinez vs. Court of Appeals, 56 SCRA 647 [1974].) This is especially true where the contract is aleatory in nature.[17]

EXAMPLE:

B bought a parcel of land from S who informed him before the contract was perfected that the land was involved in a litigation in which C is the claimant.

In case the land is recovered later on by C, B cannot allege mistake in his contract because he knew the risk that the land might later on be recovered by C.

**ART. 1334. Mutual error as to the legal effect of an agreement when the real purpose of the parties is frustrated, may vitiate consent.**

### Meaning of mistake of law.

*Mistake of law* is that which arises from an ignorance of some provisions of law, or from an erroneous interpretation of its meaning, or from an erroneous conclusion as to the legal effect of an agreement, on the part of one of the parties.

### Effect of mistake of law.

As a rule, mistake of law does not invalidate consent because "ignorance of the law excuses no one from compliance therewith." (Art. 3.) This doctrine is based on public policy, dictated by expediency and necessity. (see Luna vs. Linatoc, 74 Phil. 15 [1942].)

### When mistake of law vitiates consent.

"Mistake of law does not generally vitiate consent. But when there is a mistake on a doubtful question of law, or on the construction or application of law, this is analogous to a mistake a fact, and the maxim of *ignorantia legis neminem excusat* (ignorance of law excuses no one)

[17]Art. 2010. By an aleatory contract, one of the parties or both reciprocally bind themselves to give or to do something in consideration of what the other shall give or do upon the happening of an event which is uncertain, or which is to occur at an indeterminate time. (1790)

should have no proper application. When even the highest courts are sometimes divided upon difficult legal questions and when one-half of the lawyers in all controversies on a legal question are wrong, why should a layman be held accountable for his honest mistake on a doubtful legal issue?'' (Report of the Commission, p. 130; see Art. 1331.)

**Requisites for the application of Article 1334.**

For the article to apply, the following requisites must be present:

(1) The error must be mutual;

(2) It must be as to the legal effect of an agreement; and

(3) It must frustrate the real purpose of the parties.

EXAMPLES:

(1) D borrows P10,000.00 from C. As security for the debt, it was agreed that D should mortgage his parcel of land in favor of C. However, the document as written is one of antichresis,[18] the parties erroneously believing that it has the same effect as a mortgage.

In this case, the contract of antichresis is voidable because there is no meeting of the minds. (Art. 1359, par. 2.)

(2) In the same example, if the parties really agreed on a sale, but the document as written discloses a mortgage, there is a meeting of the minds but the document does not show their true intention.

In this case, the remedy is reformation. (see Art. 1359.)

(3) C delivers, as a deposit, a movable property to D, who receives it as loan (commodatum). (see Art. 1316.)

Here, the mutual error is not on the legal effect, but on the nature of the contract entered into. There is no meeting of the minds. D must return the property as there is neither a deposit nor a loan.

**ART. 1335. There is violence when in order to wrest consent, serious or irresistible force is employed.**

[18]Art. 2132. By the contract of antichresis the creditor acquires the right to receive the fruits of an immovable of his debtor, with obligation to apply them to the payment of the interest, if owing, and thereafter to the principal of his credit. (1881)

*Note:* In a (real estate) mortgage, the creditor-mortgagee does not have any right to receive the fruits of the property mortgaged as security for the payment of the sum borrowed by the debtor-mortgagor.

**There is intimidation when one of the contracting parties is compelled by a reasonable and well-grounded fear of an imminent and grave evil upon his person or property, or upon the person or property of his spouse, descendants or ascendants, to give his consent.**

**To determine the degree of the intimidation, the age, sex and condition of the person shall be borne in mind.**

**A threat to enforce one's claim through competent authority, if the claim is just or legal, does not vitiate consent. (1267a)**

### Nature of violence or force.

Violence requires the employment of physical force. Under Article 1335, to make consent defective, the force employed must be either serious or irresistible. In either case, consent is not free. (Report of the Code Commission, p. 136.) It is essential that the force employed must be the determining cause or reason for giving consent.

### Nature of intimidation or threat.

Under the above article, for intimidation to vitiate the consent of a party to a contract, the following requisites must be present:

(1) It must produce a reasonable and well-grounded fear of an evil;

(2) The evil must be imminent and grave;

(3) The evil must be upon his *person* or *property,* or that of his *spouse*, *descendants*, or *ascendants;* and

(4) It is the reason why he enters into the contract.[19]

Intimidation need not resort to physical force. Intimidation is internal while violence is external. Bare allegations of threat or force do not constitute substantial evidence to support the annulment of consent.

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[19]In *De Leon vs. Court of Appeals* (186 SCRA 365 [1990].), the requisites are stated as follows: (1) The intimidation must be the determining cause of the contract, or must have caused the consent to be given; (2) The threatened act must be unjust or unlawful; (3) The threat must be real and serious, there being an evident disproportion between the will and the resistance which all men can offer, leading to the choice of the contract as the lesser evil; and (4) It must produce a reasonable and well-grounded fear from the fact that the person from whom it comes has the necessary means or ability to inflict the threatened injury.

ILLUSTRATIVE CASES:

1. *Threat by a person who does not have the necessary means to inflict the threatened injury.*

*Facts:* Upon S's refusal to sell his land to B who offered to purchase the same, the latter, a foreman of the Bureau of Public Works, told S that it would better for him to sell the land because it would be expropriated by the government. Through fear and apprehension, S sold the land.

*Issue:* Has S the right to have the sale annulled on the ground of intimidation?

*Held:* No. S could not have entertained, upon B's representation, reasonable and well-grounded fear of serious injury, for S knew or ought to have known that compensation would be given her for the land in the event of expropriation.

Furthermore, it is essential that the person from whom the intimidation comes has the necessary means to inflict the threatened injury. B was a mere foreman and it was not reasonable for S to suppose that simply because he refused to sell his land B could set the government in motion to get his property by eminent domain, which, by the way, could not very well be legally classified as an imminent, serious and wrongful injury to him. *(Alarcon vs. Kasilag, [CA] 40 O.G. 11 Suppl., No. 15, p. 203.)*

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2. *Threat by a party to refuse to comply with the terms of a verbal stipulation unless there is an additional consideration for such compliance.*

*Facts:* S executed a contract of sale which on its face conveyed in fee simple a parcel of land to B. S alleged that there was a verbal stipulation giving him the right to repurchase the property at any time, and taking advantage of this fact, B threatened to refuse to reconvey if S would not sell to B another property of the former, and that because of said threat, S sold the second property.

S even entered into another verbal agreement whereby he paid B an additional consideration to obtain the first property allegedly because B still refused to reconvey the same. B subsequently reconveyed the first property to S.

*Issue:* Upon the facts was the consent of S to the second conveyance procured by means of intimidation of the character described by law?

*Held:* No. A threat to refuse to comply with the terms of a contract without an additional consideration is not, of itself, intimidation. It is an offer to make a new contract, to establish new relations, with a statement from the offerer that he will no longer abide by the old contract. Such an

act does not put the other party in the power or under the control of the one making the threat. He can still exercise judgment and will; he still remains free to secure the same redress which every other person can obtain who is injured by a breach of contract. There is nothing in this which engenders a well-grounded fear of imminent and grave evil upon person or property which destroys volition and chains the will.

Furthermore, it is impossible for S, after having been deprived of the property by intimidation, to recover that property through a voluntary agreement between him and B who intimidated him, and then repudiate not only the transaction in which he was deprived of that property, but also the very transactions by which he recovered it. By his repurchase of the property, S elected to take the conveyance as a final termination of all their relations in connection therewith. Therefore, even if there was intimidation, S has placed himself in a position where he was not entitled to urge it as a defense. *(Vales vs. Villa, 35 Phil. 769 [1916].)*

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3. *Contract was signed under threat of being imprisoned for failure to obey a court order.*

*Facts:* G, who was appointed by the court as guardian over certain minors, was induced by B to sign a contract making himself responsible for certain obligations of his former wards through fear that he be again imprisoned by the court for his failure to obey the order to render an account as guardian and to deliver the property of the guardianship to his successor.

G brought action to annul the contract on the ground of intimidation and violence.

*Issue:* Is G entitled to the relief demanded by him?

*Held:* No. Had G under the order for accounting through fear of imprisonment for failure to comply with such order, rendered an account, clearly an account rendered under such circumstances would not be subject to annulment as procured by violence or intimidation. If this is true, then an accounting of the matters in controversy and an agreement entered into in pursuance of such between the parties to the litigation, in order to avoid such an accounting, should not have this effect.

The order of the court is that G should render an account and not that he should execute the contract in question. The compliance with such order would have relieved him from imprisonment without regard to whether he should execute the contract or not. And notwithstanding the execution of this contract, the court might still have required a

compliance with its orders and inflicted a new imprisonment upon G for the failure to comply, though it is hardly probable that such a course would have been pursued after the parties to the controversy had reached an agreement in the case. *(Doronilla vs. Lopez, 3 Phil. 360 [1904].)*

**Factors to determine degree of intimidation.**

Whether or not the fear is reasonable and well-grounded or the evil imminent and grave depends upon the circumstances, including the age, sex, and condition of the person.

If a contract is signed merely out of *reverential fear* or the fear of displeasing a person to whom respect and obedience are due, the contract is valid because reverential fear by itself does not annul consent in the absence of actual threat (Sabalvaro vs. Erlanger, 64 Phil. 588 [1937].), unless the fear so deprives one of a reasonable freedom of choice as to justify the reasonable inference that undue influence has been exercised. (see Art. 1337.)

**Threat to enforce a just or legal claim.**

The threat of a court action as a means to enforce a just or legal claim is justified and does not vitiate consent. It is a practice followed by creditors to demand payment of their accounts with the threat that upon failure to do so an action would be instituted in court. Such a threat is proper within the realm of the law as a means to enforce collection. Such threat cannot constitute duress even if the claim proves unfounded so long as the creditor believes that it was his right to do so. (E. Berg vs. NCBNY, 102 Phil. 309 [1957].) For example, foreclosure of mortgaged property in case of default in payment of a debt is a legal remedy afforded by law, to a creditor; hence, a threat to foreclose the mortgage would not, *per se,* vitiate consent. (Development Bank of the Phils. vs. Perez, 442 SCRA 238 [2004].)

"So that a debtor who consents to pay under a threat of recourse to the courts and the expenses of litigation cannot maintain that his consent was null; but it will be otherwise if, passing beyond the limits of his rights, a creditor has exacted from a debtor with these same legal threats a novation of the contract or a concession of a larger indebtedness." (Jalbuena vs. Ledesma, 8 Phil. 601 [1907], citing Manresa.)

**Effect of general or collective feeling of fear.**

(1) To make consent defective, there must be specific act or acts of violence or intimidation inflicted upon the other party of such nature and magnitude as to have, in themselves, caused fear or terror upon said party, in order that his execution of the questioned deed or act cannot be considered voluntary. Accordingly, it has been held in many cases, that mere "general or collective feeling of fear" of the Japanese army during the war was not sufficient to cause the nullification of acts executed during the enemy occupation. (Lacson vs. Granada, 1 SCRA 876 [1961].)

(2) Where, however, the evidence of the person seeking invalidation of a contract of sale made during the Japanese occupation showed that he was inspired by a reasonable and well-grounded fear of suffering an imminent and serious injury to his person or property, including that of his family, if he did not execute the deed of sale to his property as demanded by the Japanese army authorities, the case was held not covered by the theory of "collective" or "general" duress according to which the general feeling of fear which Filipinos felt for the Japanese during the years of occupation, unaccompanied by any particular coercive action on the part of the latter, does not invalidate a contract. (Laperal vs. Rogers, 13 SCRA 27 [1965].)

ILLUSTRATIVE CASES:

1. *Theory of collective or general duress applied.*

*Facts:* S filed a complaint against B for the annulment, for lack of consent, of a deed of sale by the former in favor of the latter during the Japanese occupation. S claims that his consent to the contract was vitiated by the fear that his refusal to accept the military notes tendered by B would endanger his life and those of his family.

S, however, failed to cite any specific act of duress.

*Issue:* Is the claim of S tenable?

*Held:* No. The Supreme Court has repeatedly held that in order to cause the nullification of acts executed during the occupation, the duress or intimidation must be more than the "general feeling of fear" on the part of the occupied over the show of might by the occupant. In other words, aside from such "general" or "collective apprehension," there must be specific acts or instances of such nature and magnitude as to have, of themselves, inflicted fear or terror upon the subject thereof

that his execution of the questioned deed or act cannot be considered voluntary. *(Lacson vs. Granada, supra.)*

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2. *When theory not applicable.*

*Facts:* S executed during the Japanese occupation on April 12, 1944, a deed of sale of a residential lot and building in favor of the occupation Republic of the Philippines for the sum of P500,000.00 in Japanese Military War Notes.

It appeared that S was dealing not with an ordinary Japanese soldier but, first, with a group of Japanese soldiers headed by a Japanese officer noted for their arrogance and ruthlessness, and who cowed him to go to the Office of the Japanese Military Administration and once in that Office, he was in contact with two high-ranking Japanese officers, who were equally overbearing and who warned S that his refusal to sell his property constituted a hostile act; and lastly, with General Wachi who reminded S that non-cooperation was bad. Wachi shouted at S when the latter reasoned out that he could not sell his property because he had already given it to his daughter.

*Issue:* Upon the facts, did S execute the deed of sale in question under duress?

*Held:* Yes, as proved by the following circumstances:

(1) It is of common knowledge that, during the second world war, the Japanese army of occupation in the Philippines did occupy and take property in the City of Manila and elsewhere in the country without the consent of their respective owners, for their use in the prosecution of the war resorting in some cases to the expedient of making the owners execute deeds of sale or contracts of lease.

(2) Before the war and at the time of the execution of the questioned sale, S was a very rich man with very extensive real estate holdings principally in Manila and from 1914 up to the date of said sale, he had not disposed of a single property.

(3) The consideration paid for the property was grossly inadequate it appearing that its actual value of P200,000.00, Philippine currency, if reduced to its equivalent in Japanese Military Notes, would have meant around P2,800,000.00. Instead, he was paid merely P500,000.00 in Japanese Military Notes, or the equivalent of something around P35,000.00, Philippine Currency, at the time.

The theory of "collective" or "general" duress *(supra.)* is not applicable. The warnings that his refusal to sell his property was bad

and constituted a hostile act, were sufficient to give S an inkling of what would happen to him and his family if he showed non-cooperation for it was of common knowledge that many were tortured and killed by the Japanese invaders on flimsy reasons or on signs of lack of cooperation. *(Laperal vs. Rogers, supra.)*

**Threat to prosecute spouse.**

In a case, it has been held that the threat of sending to jail a husband amounts to the intimidation of his wife, who, constrained thereby, signed a document guaranteeing with her property the obligation contracted by her husband. (Jalbuena vs. Ledesma, 8 Phil. 601 [1907].)

Not every contract, however, made by a wife to relieve her husband from the consequences of his crime is voidable. Subject to certain restrictions, a wife may legally dispose of her property as she pleases. She may give it away. She may pledge or transfer it to keep her husband from legal prosecution. The question in each case is the same, was she acting from fear or according to the dictates of her judgment? (Martinez vs. Hongkong & Shanghai Bank, 15 Phil. 252 [1910].)

ILLUSTRATIVE CASES:

1. *The signing of contract of suretyship by wife was expressly made the condition of non-imprisonment of her husband.*

*Facts:* W, wife of H, was threatened by a provost judge that he "will have her husband sent back to jail," for failure of H to render his accounts as guardian of certain minors, if W would not sign a document guaranteeing with her property the obligation of her husband.

W brought action to annul the contract of suretyship. It appeared that the provost court had no jurisdiction to issue the order of imprisonment of H nor over the subject matter.

*Issue:* Did the threat constitute intimidation sufficient to annul the contract?

*Held:* Yes. In this case, the signing of the undertaking has been insisted upon by the judge in the presence and at the instance of the opposing party, and to have been expressly made the condition of non-imprisonment, amid circumstances of procedure quite unusual in courts of justice, in a tribunal convened under military auspices and exercising extraordinary powers. So that there would be reason to say that the consent of the surety was obtained by coercion. *(Jalbuena vs. Ledesma, supra.)*

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2. *Wife sold her property as consideration for settlement of criminal case against her husband on advice of her attorneys.*

*Facts:* As a consideration for the settlement of a criminal complaint for embezzlement filed by X Company against H, the former insisted upon the conveyance of all the property of H and a certain property of his wife, W. W strictly objected to the conveyance of her property, but later acceded to the terms proposed by X upon the advice of her attorneys and her relatives.

W brought action to set aside the contract on ground of duress and undue influence.

*Issue:* Upon the facts, did W enter into the contract in question by reason of duress and undue influence?

*Held:* No. The case of *Jalbuena vs. Ledesma, supra,* cannot be used as authority in the case at bar. A careful analysis of this case discloses the following peculiarities:

(1) The first offers of compromise were made by W herself through her representatives;

(2) There were at no time during the course of the negotiations for settlement any direct personal relations or communications between the parties to the action;

(3) W, by means of negotiations and settlement in question, was engaged partly at least in the settlement of her suits over her property conveyed which was the subject of adverse claims filed by third persons; and

(4) W never at any time stood alone in the negotiations but had the assistance and counsel of attorneys known for their skills and experience.

In believing and accepting the advice of her attorneys, W acted according to the dictates of good business judgment rather than from duress and undue influence. *(Martinez vs. Hongkong & Shanghai Bank, supra.)*

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3. *Wife paid creditor of her deceased husband insured under a life insurance policy under threat of lawsuit and exposure that her insurance claim was fraudulent.*

*Facts:* H, an insured under a life insurance policy, died leaving his widow, W, a beneficiary. C, a creditor of H, threatened W that if the latter would not pay the indebtedness of H, C would institute suit and allege not only fraud but that H met his death through other than accidental means.

Upon receipt of the insurance money, W paid C. It appeared that she paid C his credit upon the advice of her lawyers who assisted her

throughout the negotiations because she wanted to obtain the release of the balance of the insurance money, as she was then in dire need.

*Issue:* Has W the right to recover the payment made on the ground that she did so on by reason of C's intimidation?

*Held:* No. Article 1335 is not applicable. She made the payment not because of the fear of litigation threatened by C but in order to obtain the release of the insurance. *(Tapia Vda. de Jones vs. Carmen and Elser, 60 Phil. 756 [1954].)*

**ART. 1336. Violence or intimidation shall annul the obligation, although it may have been employed by a third person who did not take part in the contract. (1268)**

### Violence or intimidation by a third person.

Violence or intimidation may be employed by a third person who did not take part in the contract. However, to make the contract voidable or annullable, it is necessary that the violence or intimidation must be of the character required in Article 1335.

**ART. 1337. There is undue influence when a person takes improper advantage of his power over the will of another, depriving the latter of a reasonable freedom of choice. The following circumstances shall be considered: the confidential, family, spiritual and other relations between the parties, or the fact that the person alleged to have been unduly influenced was suffering from mental weakness, or was ignorant or in financial distress. (n)**

### Meaning of undue influence.

The rule as to what constitutes *undue influence* has been variously stated but the substance of the different statements is that, to be sufficient, the influence must be of a kind that so overpowers and subjugates the mind of a party as to destroy his free agency and make him express the will of another, rather than his own. (Coso vs. Fernandez-Deza, 42 Phil. 596 [1921].)

### Elements of undue influence.

The existence of undue influence depends upon the circumstances of each case and not on bare academic rules. It must be shown by

clear and convincing evidence. For undue influence to be established to justify the cancellation of an instrument, three elements must be present:

(1) a person who can be influenced;

(2) the fact that improper influence was exerted; and

(3) submission to the overwhelming effect of such unlawful conduct.

Undue influence is not to be inferred alone from age, sickness, or debility of body, if sufficient intelligence remains. (Loyola vs. Court of Appeals, 326 SCRA 285 [2000].) The influence must be undue or improper (Art. 1337.) to avoid a contract. Mere general or reasonable influence is not sufficient. If gained by kindness and affection or argument and persuasion, the influence will not vitiate consent. (Coso vs. Fernandez-Daza, *supra*; Martinez vs. Hongkong & Shanghai Bank, 15 Phil. 252 [1910].)

**Due influence and undue influence distinguished.**

Solicitation, importunity, argument, and persuasion are not undue influence and a contract is not to be set aside merely because one party used these means to obtain the consent of the other. Influence obtained by persuasion or argument or by appeals to the affection is not prohibited either in law or morals and is not obnoxious even in courts of equity. Such may be termed "due influence." (13 C.J. 405; see Banes vs. Court of Appeals, 59 SCRA 15 [1974]; Loyola vs. Court of Appeals, *supra*.)

The line between due and undue influence, when drawn must be with full recognition of the liberty due every true owner to obey the voice of justice, the dictates of friendship, of gratitude, or of benevolence, as well as the claims of kindred, and, when not hindered by personal incapacity or particular regulations, to dispose of his own property according to his own free choice. On the other hand, influence attained by superiority of will, mind, or character under circumstances which give dominion over the will of another to such an extent as to destroy free agency or to constrain him to do against his will what he is unable to refuse, is such influence as the law condemns as undue. (see *Ibid.;* Martinez vs. Hongkong & Shanghai Bank, *supra*.)

If a competent person has once assented to a contract freely and fairly, he is bound thereby. (Alcasid vs. Court of Appeals, 237 SCRA 419 [1994].)

ILLUSTRATIVE CASE:

*Contract to sell was awarded to another person after intercession of a member of the legislative body.*

*Facts:* PHHC (People's Homesite and Housing Corp.), a government instrumentality, awarded to B a lot owned by the former pursuant to a conditional contract to sell. B transferred his right to X with the approval of PHHC. Y protested the sale to B claiming preferential right to purchase the lot and the transfer to X claiming that X acquired no rights to the lot because of the failure of B to comply with the (resolutory) condition of the contract and that the approval of the transfer was due to the intercession of Senator F who sent a letter to the Board of Directors of PHHC requesting approval of sasid transfer.

*Issue:* Upon the facts, may it be said that the approval of the transfer was vitiated by undue influence?

*Held:* No. The transfer could not have been approved solely on the strenght of such letter, for the approval was recommended as "extremely meritorious" by the Head Executive Assistant and the Homesite Sales Supervisor of the PHHC. The letter could not destroy the free agency of the PHHC Board of Directors, and could not have interfered with the exercise of the Board's independent discretion. *(Bañez vs. Court of Appeals, supra.)*

**Circumstances to be considered.**

The following are examples of circumstances which shall be considered to determine whether undue influence has been exercised:

(1) confidential, family, spiritual and other relations between the parties,

(2) mental weakness,

(3) ignorance, or

(4) financial distress of the person alleged to have been unduly influenced. (Art. 1337; see Art. 1332.)

Article 24 of the Civil Code enjoins courts to be vigilant for the protection of a party to a contract who is placed at a disadvantage on account of his ignorance, mental weakness or other handicap. (see Katipunan vs. Katipunan, Jr., 375 SCRA 200 [2002].)

EXAMPLE:

T, a tenant, is in need of P5,000.00 to pay L, his landlord who is seeking to eject him for failure to pay the rents. T tries to borrow from C but the latter instead tells him to sell his piano for P5,000.00. T has nobody to turn to for assistance.

If T does not want to sell the piano but he is compelled to sell it because of his financial condition, the sale may be avoided on the ground of undue influence.

"Agreements between lender and borrower are closely scrutinized because they are not always at arm's length." (13 C.J. 410.)

**ART. 1338. There is fraud when, through insidious words or machinations of one of the contracting parties, the other is induced to enter into a contract which, without them, he would not have agreed to. (1269)**

### Meaning of causal fraud.

*Causal fraud* or *dolo causante* is the fraud employed by one party prior to or simultaneous with the creation of the contract to secure the consent of the other. It is the fraud used by a party to induce the other to enter into a contract without which the latter would not have agreed to, taking into account the circumstances of the case.

The fraud must be that which determines or is the essential cause of the contract. (Caram, Jr. vs. Laureta, 103 SCRA 7 [1981].) The fraud contemplated in this article and mentioned in Article 1330 is causal fraud involving the use of deceit or deception. It must be distinguished from the fraud dealt with in Article 1170.

### How causal fraud committed.

Causal fraud may be committed through insidious words or machinations (Art. 1338.) or by concealment. (Art. 1339.)

(1) According to Manresa, *insidious words* or *machinations* "include false promises, exaggerated expectations or benefits, abuse of confidence, fictitious names, qualities, or power; in fine, the thousand forms of fraud, which can deceive a contracting party, producing a vitiated consent" (8 Manresa 677.), and it is not necessary that they constitute estafa or partake of any other criminal act subject to the penal law. (Eguaras vs. Great Eastern Life Assurance Co. and Smith, 33 Phil. 263

[1915].) It has been held that where one states that the future profits or income of an enterprise shall be a certain sum but he actually knows that there will be none, or that they will be substantially less than he represents, the statements constitute an actionable fraud where the hearer believes him and relies on the statements to his injury. (People vs. Menil, Jr., 340 SCRA 125 [2000].)

"Insidious machinations" may be said to be a deceitful scheme or plot with an evil design, or in other words, with a fraudulent purpose. Thus, deceit which avoids a contract need not be by means of misrepresentation in words. (Strong vs. Gutierrez Repide, 41 Phil. 947, 213 U.S. 419, *infra;* see Caram, Jr. vs. Laureta, *supra*; Cathay Pacific Airways, Ltd. vs. Vasquez, 399 SCRA 207 [2003].) The false representation may be made by conduct. *Fraud,* in its general sense, embraces all multifarious means which human ingenuity can device and which are resorted to by one individual to secure an unfair advantage by which another is cheated. (see Garcia vs. People, 410 SCRA 582 [2003]; Sim, Jr. vs. Court of Appeals, 428 SCRA 459 [2004].) It is deemed to comprise anything calculated to deceive. *Deceit* is a species of fraud. It is the false representation of a matter of fact, by false or misleading allegations or by concealment which deceives or intended to deceive another. (Uy vs. People, 564 SCRA 542 [2008].)

(2) Causal fraud may also be committed by means of *concealing or omitting to state material facts*, when there is a special duty to disclose the same, with intent to deceive, by reason of which concealment or omission, the other party was induced to give a consent which he would not otherwise have given. (Strong vs. Gutierrez Repide, *infra*; see Maestrado vs. Court of Appeals, 327 SCRA 678 [2000].) Fraudulent nondisclosure and fraudulent concealment are of the same genre. (Guinhawa vs. People, 468 SCRA 278 [2005].)

A debt, for example, is fraudulently contracted if at the time of contracting it, the debtor has a preconceived plan or intention not to pay. Fraud is a state of mind and need not be proved by direct evidence but may be inferred from the circumstances attendant in each case. Fraud is a state of a mind and need not be proved by direct evidence. Fraudulent intent cannot be inferred from the debtor's inability to pay or to comply with his obligation. (Liberty Insurance Corporation vs. Court of Appeals, 222 SCRA 37 [1993]; FCY Construction Groups, Inc. vs. Court of Appeals, 324 SCRA 270 [2000]; Philippine Bank of Communication vs. Court of Appeals, 352 SCRA 316 [2001].)

If the fraud did not have the effect of causal fraud, that is, it did not by itself alone cause the other contracting party to give his consent, it gives rise only to an action for damages. (see Art. 1344, par. 2.)

**Requisites of causal fraud.**

Not all forms of fraud can vitiate consent. In order that fraud may vitiate consent and be a cause for the annulment of a contract, the following requisites must be present:

(1) There must be misrepresentation or concealment (Arts. 1338, 1339.) by a party prior to or simultaneous to the consent or creation of the contract (Caram, Jr. vs. Laureta, *supra.*);

(2) It must be serious (Art. 1344.);

(3) It must have been employed by only one of the contracting parties. *(Ibid.)* Fraud committed by a third person does not vitiate consent unless it was practiced in connivance with or at least with the knowledge of the favored contracting party (see Art. 1342.);

(4) It must be made in bad faith or with intent to deceive (see Art. 1343.) the other contracting party who had no knowledge of the fraud;

(5) It must have induced the consent of the other contracting party (Art. 1338.); and

(6) It must be alleged and proved by clear and convincing evidence, and not merely by a preponderance thereof. (Tan Sua Sia vs. Sontua, 56 Phil. 707 [1932]; Sy Tiangco vs. Pablo, 59 Phil. 119 [1933]; Caragay vs. Urquiza, 58 Phil. 81 [1933]; Alonzo vs. Granada, 18 Phil. 482 [1911]; Centenera vs. Palicia, 29 Phil. 470 [1915]; Maestrado vs. Court of Appeals, 327 SCRA 678 [2000]; Cebu Country Club, 417 SCRA 115 [2003].) So it is not enough that evidence offered to prove fraud is more convincing or worthy of belief than that which is offered in opposition thereto.

Fraud is a question of fact (Jaramil vs. Court of Appeals, 78 SCRA 420 [1977].) although it may be proved by circumstantial evidence. Applied to contracts, the presumption is in favor of validity and regularity. (Loyola vs. Court of Appeals, 326 SCRA 285 [2000].) Mere weakness of mind alone, without imposition of fraud, is not a ground for vacating a contract. Only if there is unfairness in the transaction, such as gross inadequacy of consideration or the low degree of intellectual capacity of a party may it be taken into consideration for the purpose

of showing such fraud as will afford a ground for annulling the contract. (Yason vs. Arciaga, 449 SCRA 458 [2005].)

EXAMPLES:

(1) S offered to sell to B a ring claiming that the stone on the ring is diamond. S knows that it is not diamond but ordinary glass.

If B buys the ring, relying on the truth of the representation of S, the sale may be annulled on the ground of fraud.

(2) S sold to B a parcel of land representing that the same was "absolutely free of all liens and encumbrances." B gave his consent on the faith of S's representation. When the sale was registered, it was found that a *lis pendens* notice was annotated on the title to the land.

In this case, the concealment constitutes fraud such as justifies the avoidance of the sale, and entitles B to damages. (see Pineda vs. Santos, 56 Phil. 584 [1932].)

(3) S sold to B a house and lot, misrepresenting that the place was accessible to means of transportation. The sale is voidable on the ground of fraud if B was induced to give his consent because of the representation.

But if B purchased the property without any inducement from B, his mistaken belief that it was accessible does not vitiate consent because the error refers merely to an incidental quality or condition of the thing. (see Art. 1331.)

ILLUSTRATIVE CASES:

1. *Representation made was merely a statement of belief or expectation.*

*Facts:* X was induced by Y to finance the Counter-Point magazine because Y informed him that Freedom Press, which they were going to acquire, was capable of printing a magazine. Y assured X that the magazine would break even after the first issue, but it did not, that it would make money in the next issue, and when it failed again, said that it would make money in the subsequent issues.

*Issue:* Was Y's representation that the business would be successful fraudulent?

*Held*: No. Such failure might have been the result of errors of judgment, and consequently, fraud and bad faith could hardly be attributed to Y. There is no such thing as a royal road that leads to profits, in any civil or commercial undertaking anywhere, anytime and for any class of people, no matter how experts they are in the undertaking.

Business enterprises, no matter how auspicious the time under which they might have been inaugurated, are not self-assuring of their eventual success. Business ventures prosper and fail in the course of time, depending upon various factors — the competency of the management, the trend of business depending upon the fundamental law of supply and demand, and undeniably, upon the unpredictable circumstances which might affect them one way or the other. And luck is a prominent factor in this last requisite. *(Smith vs. Counter-Point Publishing Co., Inc., [CA] No. 18338-R, April 18, 1960.)*

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2. *Insurer refused to pay beneficiary on the ground of fraud, but the latter was subsequently acquitted in a criminal case for estafa based on the fraud.*

*Facts:* In connivance with an agent of X (insurance company), another man was examined by X's physician in place of the insured applicant. Subsequently, the insured died. B, as beneficiary, demanded payment from X which refused to pay on the ground of fraud.

During the pendency of the action brought by B against X, B and the agent were prosecuted for estafa but they were acquitted.

*Issue:* Did the acquittal of B have the effect of nullifying the defense that the contract of insurance was procured through fraud?

*Held:* No. In the present civil suit, it is not a question whether the acts performed by B and her co-accused partook of the nature of the crime of estafa, but whether in taking out the insurance on the life of the deceased there was fraud of a civil nature, in the form and under the conditions defined by the Civil Code.

Therefore, the judgment of acquittal rendered in the criminal case did not produce the effect of *res judicata* in the civil suit to the extent that because B was acquitted of the crime of estafa, she has necessarily acquired, as beneficiary, the right to collect the value of the insurance. *(Eguaras vs. Great Eastern Life Assur. Co. and Smith, 33 Phil. 263 [1916].)*

**ART. 1339. Failure to disclose facts, when there is a duty to reveal them, as when the parties are bound by confidential relations, constitutes fraud. (n)**

## Fraud by concealment.

A neglect or failure to communicate that which a party to a contract knows and ought to communicate constitutes *concealment*. In this case, concealment is equivalent to misrepresentation. (see Insurance Code

of 1978 [Pres. Decree No. 1460], Sec. 26.) Silence or concealment by itself does not constitute fraud. The concealment contemplated in Article 1339 presupposes a purpose or design to hide facts which the other party ought to know.

The injured party is entitled to cancel or annul a contract whether the failure to disclose the material facts is intentional or unintentional as long as there is a duty to reveal or disclose them or according to good faith such disclosure should be made and the other party is misled or deceived in entering into the contract. If the failure is unintentional, the basis of the action for annulment is not fraud but mistake or error (Art. 1343.); if unintentional and there is no duty to make the disclosure, the parties are bound by their contract.

Articles 1339 to 1343 embody rules originating from the American law on fraud in contracts. (Report of the Code Commission, p. 136.)

EXAMPLES:

(1) X and Y are partners engaged in the real estate business. Here, the parties are bound by confidential relations. X learned that C was interested in buying a certain parcel of land owned by the partnership even for a high price. Without informing Y, X was able to make Y sell to him (X) his (Y's) share in the partnership. Then, X sold the land at a big profit.

In this case, X is guilty of fraudulent concealment because he was under the duty to make disclosure of facts having a bearing on the value of the interests of Y in the partnership which were not known to Y. (see Art. 1806.)

If the sale was at the initiative of Y, and X unintentionally failed to inform Y of C's offer, the cause for annulment is mistake or error on the part of Y.

(2) S sold to B stocks traded in the stock exchange at a certain price. S believed that the price of the stocks would go down and it did. The sale is valid because S was not bound to make disclosure of his reasons for his belief.

ILLUSTRATIVE CASES:

1. *Agent, through misrepresentation of the condition of the market, succeeded in making principal sell to him goods at a lower price.*

*Facts:* A, consignee, as agent of P, principal in the sale of piles, informed P that for lack of demand, the piles had to be sold at considerably less

than $15.00 a pile, in response to which P offered the price of $12.00 a pile which offer was accepted by A. It appeared that A had been negotiating with the government for the sale of the piles for $20.00 a pile, which negotiation resulted in the sale to the government of 213 piles at $19.00 each. More of the piles were afterwards sold to the government and other parties.

P brought action for the annulment of the contract of sale with A and for the recovery of a sum above the amount (*i.e.*, $12.00 per pile sold) paid by A to P.

*Issue:* Was A guilty of fraud?

*Held:* Yes. In concealing from P the negotiations with the government, and in misrepresenting the condition of the market, A committed a breach of duty from which he should not benefit. The contract of sale to himself thereby induced was founded on his fraud and was subject to annulment by the aggrieved party, P. Upon the annulment, the parties should be restored to their original position by mutual restitution. *(Cadwallader & Co. vs. Smith, Bell & Co., 7 Phil. 461 [1907].)*

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2. *Vendee of shares concealed his identity as purchaser, being the managing director and majority stockholder of the corporation, and his knowledge of a negotiation with the government which if successful would enhance the price of the stock.*

*Facts:* B, a managing director of a corporation and, in his own right, a majority stockholder thereof, purchased, through an agent, the shares of S, another stockholder. He did not inform the latter of the pending sale of friar lands owned by the company to the government, which, if successful, would greatly enhance the price of the stock.

B concealed his identity, as vendee. Being the holder of a large majority of the stock, B not only controlled the negotiations with the government but also its ultimate result by his own vote in the shareholders' meeting.

*Issue:* Was B guilty of fraud for not disclosing either his information or his intention, or even his identity?

*Held:* Yes. He procured the purchase *by insidious machinations* within the meaning of Article 1338, when he employed an agent to make the purchase, concealing both his own identity as the purchaser and his knowledge of the state of the negotiations and their probable successful result. Under all the circumstances of the case, it was his duty, acting in good faith, to have disclosed the facts which he concealed. *(Strong vs. Gutierrez Repide, 41 Phil. 947 [1921].)*

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3. *Lessee with right of first refusal, offered to buy leased property at P5,000 per square meter, which property was sold by the lessor-owner to another for P5,300 per sq. meter.*

*Facts:* Under the contract of lease executed by defendant Reyes (lessor) with plaintiff Riviera (lessee), the "Lessee shall have the right of first refusal should the lessor decide to sell the property during the term of the lease."

Since the beginning of the negotiation between the plaintiff and defendant Reyes for the purchase of the property, in question, the plaintiff was firm and steadfast in its position, expressed in writing by its President Vicente Angeles, that it was not willing to buy the said property higher than P5,000.00, per square meter, which was far lower than the asking price of defendant Reyes for P6,000.00, per square meter, undoubtedly, because, in its perception, it would be difficult for other parties to buy the property, at a higher price than what it was offering, since it is in occupation of the property, as lessee, the term of which was to expire after about four (4) years more.

In the petition at bar, Riviera posits the view that its right of first refusal was totally disregarded or violated by Reyes by the latter's sale of the subject property to Cypress and Cornhill at P5,300 per square meter. It contends that the right of first refusal principally amounts to a right to match in the sense that it needs another offer for the right to be exercised.

*Issue:* Has Riviera lost its right of first refusal?

*Held:* Yes. (1) *Concept and interpretation of the right of first refusal.* — "The concept and interpretation of the right of first refusal and the consequences of a breach thereof evolved in Philippine juristic sphere only within the last decade. It all started in 1992 with *Guzman, Bocaling & Co. vs. Bonnevie* (206 SCRA 668 [1992].), where the Court held that a lease with a proviso granting the lessee the right of first priority 'all things and conditions being equal' meant that there should be identity of the terms and conditions to be offered to the lessee and all other prospective buyers, with the lessee to enjoy the right of first priority. A deed of sale executed in favor of a third party who cannot be deemed a purchaser in good faith, and which is in violation of a right of first refusal granted to the lessee is not voidable under the Statute of Frauds but rescissible under Articles 1380 to 1381(3) of the New Civil Code.

Subsequently in 1994, in the case of *Ang Yu Asuncion vs. Court of Appeals* (238 SCRA 602 [1994].), the Court *en banc* departed from the doctrine laid down in *Guzman, Bocaling & Co. vs. Bonnevie* and refused to rescind a contract of sale which violated the right of first refusal. The

Court held that the so-called "right of first refusal" cannot be deemed a perfected contract of sale under Article 1458 of the new Civil Code and, as such, a breach thereof decreed under a final judgment does not entitle the aggrieved party to a writ of execution of the judgment but to an action for damages in a proper forum for the purpose.

In the 1996 case of *Equatorial Realty Development, Inc. vs. Mayfair Theater, Inc*. (264 SCRA 483 [1996].), the Court *en banc* reverted back to the doctrine in *Guzman Bocaling & Co. vs. Bonnevie* stating that rescission is a relief allowed for the protection of one of the contracting parties and even third persons from all injury and damage the contract may cause or to protect some incompatible and preferred right by the contract.

Thereafter in 1997, in *Parañaque Kings Enterprises, Inc. vs. Court of Appeals* (268 SCRA 727 [1997].), the Court affirmed the nature of and the concomitant rights and obligations of parties under a right of first refusal. The Court, summarizing the rulings in *Guzman, Bocaling & Co. vs. Bonnevie* and *Equatorial Realty Development, Inc. vs. Mayfair Theater, Inc*., held that in order to have full compliance with the contractual right granting petitioner the first option to purchase, the sale of the properties for the price for which they were finally sold to a third person should have likewise been first offered to the former. Further, there should be identity of terms and conditions to be offered to the buyer holding a right of first refusal if such right is not to be rendered illusory. Lastly, the basis of the right of first refusal must be the current offer to sell of the seller or offer to purchase of any prospective buyer."

(2) *Prevailing doctrine.* — "Thus, the prevailing doctrine is that a right of first refusal means identity of terms and conditions to be offered to the lessee and all other prospective buyers and a contract of sale entered into in violation of a right of first refusal of another person, while valid, is rescissible. However, we must remember that general propositions do not decide specific cases. Rather, laws are interpreted in the context of the peculiar factual situation of each proceeding. Each case has its own flesh and blood and cannot be ruled upon on the basis of isolated clinical classroom principles. Analysis and construction should not be limited to the words used in the contract, as they may not accurately reflect the parties' true intent. The court must read a contract as the average person would read it and should not give it a strained or forced construction."

(3) *Riviera intractable in its position.* — "As clearly shown by the records and transcripts of the case, the actions of the parties to the contract of lease, Reyes and Riviera, shaped their understanding and interpretation of the lease provision 'right of first refusal' to mean simply that should the lessor Reyes decide to sell the leased property during the

term of the lease, such sale should first be offered to the lessee Riviera. And that is what exactly ensued between Reyes and Riviera, a series of negotiations on the price per square meter of the subject property with neither party, especially Riviera, unwilling to budge from his offer, as evidenced by the exchange of letters between the two contenders.

It can clearly be discerned from Riviera's letters dated December 2, 1988 and February 4, 1989 that Riviera was so intractable in its position and took obvious advantage of the knowledge of the time element in its negotiations with Reyes as the redemption period of the subject foreclosed property drew near. Riviera strongly exhibited a 'take-it or leave-it' attitude in its negotiations with Reyes. It quoted its 'fixed and final' price as Five Thousand Pesos (P5,000.00) and not any peso more. It voiced out that it had other properties to consider so Reyes should decide and make known its decision 'within fifteen days.' x x x."

(4) *Reyes under no obligation to Riviera to disclose his offer to another.* — "Nary a howl of protest or shout of defiance spewed forth from Riviera's lips, as it were, but a seemingly whimper of acceptance when the counsel of Reyes strongly expressed in a letter dated December 5, 1989 that Riviera had lost its right of first refusal. Riviera cannot now be heard that had it been informed of the offer of Five Thousand Three Hundred Pesos (P5,300.00) of Cypress and Cornhill it would have matched said price. Its stubborn approach in its negotiations with Reyes showed crystal-clear that there was never any need to disclose such information and doing so would be just a futile effort on the part of Reyes. Reyes was under no obligation to disclose the same. Pursuant to Article 1339 of the New Civil Code, silence or concealment, by itself, does not constitute fraud, unless there is a special duty to disclose certain facts, or unless according to good faith and the usages of commerce the communication should be made. We apply the general rule in the case at bar since Riviera failed to convincingly show that either of the exceptions are (sic) relevant to the case at bar." *(Riviera Filipina, Inc. vs. Court of Appeals, 380 SCRA 245 [2002].)*

### When misrepresentation as to age constitutes fraud.

The failure of a minor to disclose his minority when making a contract does not *per se*, constitute a fraud which can be made the basis of an action of deceit. In order to hold the minor liable, the fraud must be actual and not constructive. His mere failure to disclose his age is not sufficient. (Braganza vs. De Villa Abrille, 105 Phil. 456 [1959]; see Art. 1329.)

**ART. 1340. The usual exaggerations in trade, when the other party had an opportunity to know the facts, are not in themselves fraudulent. (n)**

## Usual exaggerations in trade.

It is the natural tendency for merchants and traders to resort to exaggerations in their attempt to make a sale at the highest price possible. When the person dealing with them had an opportunity to know the facts, the usual exaggerations in trade are not in themselves fraudulent. The law allows considerable latitude to seller's statements or dealer's talk and experience teaches that it is exceedingly risky to accept it at its face value. Customers are expected to know how to take care of their concerns and to rely on their own independent judgment. Any person who relies on said exaggerations does so at his own peril. (see Songco vs. Sellner, 37 Phil. 254 [1917].)

In effect, the law does not consider such exaggerations, even if known as false by the party making them, as amounting to fraud that will affect the validity of a contract. For where the means of knowledge are at hand and equally available to both parties, one will not be heard to say that he has been deceived. (Banga vs. Laballeco, 59 Phil. 101 [1933].) Thus, one who contracts for the purchase of real estate in reliance on the representation and statements of the vendor as to its character and value and after he has visited and examined it for himself, and has had the means and opportunity of verifying such statements, cannot avoid the contract on the ground that such statements were false or exaggerated. (Azarraga vs. Gay, 52 Phil. 599 [1928].)

*Dealer's talk* or *trader's talk* are representations which do not appear on the face of the contract and these do not bind either party. (Puyat vs. Arce Amusement Co., 72 Phil. 402 [1941].)

EXAMPLES:

Expressions or advertisements like:

"The cigarette that will give you utmost smoking pleasure"

"You like it, it likes you"

"The refreshment of friendship"

"Do you want your child to get high grades? Then, buy him X fountain pen."

"First in quality"

"The best in its class."

**ART. 1341. A mere expression of an opinion does not signify fraud, unless made by an expert and the other party has relied on the former's special knowledge. (n)**

## Expression of opinion.

To constitute fraud, the misrepresentation must refer to facts, not opinions. Ordinarily, a mere expression of an opinion does not signify fraud. In order that it may amount to fraud, the following requisites must be present:

(1) It must be made by an expert;

(2) The other contracting party has relied on the expert's opinion; and

(3) The opinion turned out to be false or erroneous.

EXAMPLE:

F, a farmer, found a ring. He does not know anything about precious stones. He sells the ring to B honestly believing, and telling B, that it is a diamond ring.

In this case, there is no fraud even if it turned out that the ring is not diamond because his statement is merely an expression of an opinion. (see Art. 1343.)

However, if F is an expert on precious stones and he sells the ring to B saying, "I believe this is a diamond ring," and B, knowing that F is an expert, relies on his special knowledge, the contract is voidable on the ground of fraud. Actually, F, being an expert, is making a misrepresentation of fact and he cannot escape liability by expressing it in the form of an opinion.

**ART. 1342. Misrepresentation by a third person does not vitiate consent, unless such misrepresentation has created substantial mistake and the same is mutual. (n)**

## Fraud by a third person.

A third person has no connection with a contract. Consequently, a misrepresentation by him does not vitiate consent. A party should not

be made to suffer for the imprudence of another in believing the fraud of a third person. The presumption is that both contracting parties are acting in good faith.

However, if the misrepresentation by the third person has created substantial mistake and the same is mutual, that is, it affects both parties, the contract may be annulled but principally on the ground of mistake, even if the deceit was without the complicity with one of the parties. If the misrepresentation has been employed by a third person in connivance with, or at least with knowledge of the party benefited by the fraud, it is deemed to have been exercised by such party upon the other contracting party. (see Hill vs. Veloso, 31 Phil. 160 [1915]; Rural Bank of Caloocan vs. Court of Appeals, 104 SCRA 151 [1981].)

It should be remembered that force or intimidation employed by a third person on one of the parties makes a contract voidable. (Art. 1336.) The reason is because the consent is vitiated just the same.

EXAMPLES:

(1) S bought the land of B for P2,000.00 per square meter. The reasonable price of lands in the same vicinity is P3,000.00 per square meter but B sold it only for P2,000.00 per square meter because C had deceived him regarding its market value.

In this case, the contract cannot be annulled unless it can be shown that S was a party to the fraud.

(2) B wants to buy a parcel of land on which to build a house. S owns a land on which he wants to construct a commercial building. C tells B and S that the area where the land is located is a residential zone. B and S then enter into a contract of sale of the land owned by S. It turns out that the area is a commercial zone.

Under the facts, the sale may be annulled because of substantial mistake which is mutual.

**Fraud must be committed by one party on the other.**

The one and the other of the contracting parties, to which Article 1338 refers, are the active and the passive subjects of the obligation. (see Art. 1156.)

A co-debtor is not *one* contracting party with regard to his co-debtor as the other contracting party. They are both but one single

contracting party in contractual relation with, or against, their creditor. A co-debtor who practiced deceit upon his co-debtor, would be, for this purpose, but a third person. There would then not be deceit on the part of one of the contracting parties exercised upon the other contracting party, but deceit by a third person. Consequently, fraud committed by a debtor upon his co-debtor cannot be raised as a defense to an action by the creditor against the deceived co-debtor. (Hill vs. Veloso, *supra*.)

**ART. 1343. Misrepresentation made in good faith is not fraudulent but may constitute error. (n)**

### Effect of misrepresentation made in good faith.

If the misrepresentation is not intentional but made in good faith (the person making the false statement believed it to be true), it is considered a mere mistake or error. Fraud is definitely more serious than mistake; hence, the party guilty of fraud is subject to greater liability.

**ART. 1344. In order that fraud may make a contract voidable, it should be serious and should not have been employed by both contracting parties.**

**Incidental fraud only obliges the person employing it to pay damages. (1270)**

### Two kinds of fraud in the making of a contract.

Article 1344 distinguishes two kinds of (civil) fraud in the making of a contract, to wit:

(1) *causal fraud,* or fraud employed to secure the consent of the other party, which is a ground for the annulment of a contract (par. 1.), although it may also give rise to an action for damages; and

(2) *incidental fraud*, or fraud likewise employed to secure the consent of the other party but which only renders the party who employs it liable for damages. (par. 2.) This kind of fraud must not be confused with the fraud in Articles 1170 and 1171 which refers to that occurring in the performance of a pre-existing obligation under a contract without affecting the validity of the contract. Both kinds of incidental fraud do not vitiate consent.

**Requisites of causal fraud.**

Under Article 1344, in order that causal fraud may vitiate consent, the following are the requisites:

(1) *It should be serious*. — The seriousness of the fraud is a question of fact depending on the circumstances. It does not mean its influence on the other contracting party, but its importance. The requirement that fraud should be serious excludes from the effects of fraud slight and usual deviations from the truth, almost inseparable, unfortunately, from transactions, especially those taking place in fairs and markets. (see 8 Manresa 679; see Art. 1341.)

The fraud or *dolo causante* must be that which determines or is the essential cause of the contract. (Caram, Jr. vs. Laureta, 102 SCRA 7 [1981].) In case the fraud is not serious or important enough to make the contract voidable, the aggrieved party is entitled to demand an adjustment in the price or consideration;

(2) *It should not have been employed by both contracting parties, i.e., they should not be in pari delicto.* — When fraud is employed by both parties, neither may ask for annulment as the fraud of one neutralizes that of the other. The contract is, therefore, considered valid. The rule is in accordance with the principle that "he who comes to court, must come with clean hands" (see Valdez vs. Sibal, 46 Phil. 930 [1924].);

(3) *It should not have been known by the other contracting party*. — Neither may a contract be set aside on the ground of fraud if the party who was defrauded knew at the time of execution of the contract all the facts upon which his claim of fraud is based (Ternate vs. Aniversario, 8 Phil. 292 [1907]; Enriquez vs. Enriquez, 8 Phil. 607 [1907].); and

(4) *It should be invoked by the proper party.* — The party entitled to invoke fraud or bad faith as a ground for nullifying a contract is the victim — the one who was tricked in giving his consent thereto. Strangers to a contract cannot sue either or both contracting parties to set aside the same except when he is prejudiced in his rights with respect to one of the contracting parties and can show detriment which would positively result to him from the contract in which he has no intervention. (Reyes vs. Court of Appeals, 216 SCRA 152 [1992]; see Art. 1397.)

### Effect of incidental fraud.

In order that fraud may vitiate consent, it must be the causal *(dolo causante)* not merely the incidental *(dolo incidente)* inducement to the making of the contract. (Hill vs. Veloso, 31 Phil. 160 [1915].)

In a case where the plaintiff misrepresented that he had an exclusive franchise and promised to transfer it to the defendant to get from the latter a big slice in the net profits, it was held that the false representation did not vitiate defendant's consent because it was used to get his consent to a big share in the profits, an incidental matter in the partnership agreement. (Woodhouse vs. Halili, 93 Phil. 526 [1953].)

In other words, the fraud was not the principal inducement that led the defendant to enter into the partnership agreement, for without the fraud, the defendant would still have freely entered into the agreement. He was deceived only as to the terms of the contract. The court found that the defendant agreed to give the plaintiff 30% of the share in the net profits because he was transferring his exclusive franchise to the partnership.

**ART. 1345. Simulation of a contract may be absolute or relative. The former takes place when the parties do not intend to be bound at all; the latter, when the parties conceal their true agreement. (n)**

**ART. 1346. An absolutely simulated or fictitious contract is void. A relative simulation, when it does not prejudice a third person and is not intended for any purpose contrary to law, morals, good customs, public order or public policy binds the parties to their real agreement. (n)**

### Meaning of simulation of a contract.

*Simulation of a contract* is the act of deliberately deceiving others, by feigning or pretending by agreement, the appearance of a contract which is either non-existent or concealed (1 Castan 504.) or is different from that which was really executed. (see Tongoy vs. Court of Appeals, 123 SCRA 99 [1993]; Villaflor vs. Court of Appeals, 280 SCRA 297 [1997]; Mendozana vs. Ozamiz, 376 SCRA 482 [2002].)

### Basic characteristic, purpose, and requisites of simulation.

(1) The basic characteristic of simulation is the fact that the apparent contract is not really desired or intended to produce legal

effects or in any way alter the juridical situation of the parties. (Carantes vs. Court of Appeals, 76 SCRA 514 [1977]; Tongoy vs. Court of Appeals, 123 SCRA 99 [1983]; Umali vs. Court of Appeals, 189 SCRA 529 [1990]; Payongayong vs. Court of Appeals, 430 SCRA 210 [2004]; Valero vs. Refresca, 485 SCRA 494 [2006].)

(2) The nullity of a simulated contract is based on the absence of true consent of the parties which is essential to a valid and enforceable contract. The purpose of simulation is to hide the parties' true intent, or to deceive or defraud third persons.

(3) The requisites for simulation are:

(a) an outward declaration of will different from the will of the parties;

(b) the false appearance must have been intended by mutual agreement; and

(c) the purpose is to deceive third persons. (Loyola vs. Court of Appeals, 326 SCRA 285 [2000]; Peñalosa vs. Santos, 363 SCRA 545 [2001].)

The primary consideration in determining the true nature of a contract is the intention of the parties. Such intention is determined from the express terms of the agreement as well as from their contemporaneous and subsequent acts. (Arts. 1370, 1371.)

**Simulated contracts distinguished from fraudulent contracts.**

The first are fictitious contracts. The second are serious, real and intended for the attainment of a prohibited result. Simulation is intended to hide the violation of law. (Carantes vs. Court of Appeals, *supra.*) But such contracts are even generally regarded as fraudulent if the purpose is to defraud third persons with intent of injuring them. (Banawa vs. Mirano, 97 SCRA 517 [1980].)

"Absolute simulation implies that there is no existing contract, no real act executed; while fraudulent alienation means that there is a true and existing transfer or contract. The former can be attacked by any creditor, including one subsequent to the contract; while the latter can be assailed only by the creditors before the alienation. In absolute simulation, the insolvency of the debtor making the simulated transfer

is not a prerequisite to the nullity of the contract; while in fraudulent alienation, the action to rescind, or *accion pauliana*, requires that the creditor cannot recover in any other manner what is due him. Finally, the action to declare a contract absolutely simulated does not prescribe (Articles 1409 and 1410); while the *accion pauliana* to rescind a fraudulent alienation prescribes in four years (Article 1389).'' (Manila Banking Corporation vs. Silverio, 466 SCRA 438 [2005].)

**Kinds of simulation.**

They are:

(1) *Absolute simulation* or when the contract does not really exist and the parties do not intend to be bound at all. (Art. 1345.) Absolutely simulated or fictitious contracts are inexistent and void (Arts. 1346, 1409[2], 1471; see Catindig vs. Heirs of Catalina Roque, 74 SCRA 83 [1976]; Castro vs. Escutin, 90 SCRA 349 [1979].) and are not susceptible of ratification. The parties may recover from each other what they may have given under the "contract.''

EXAMPLE:

D is indebted to C. Upon learning that C is going to enforce his credit, D pretended to sell his land to F, his father-in-law. D did not receive a single centavo for the deed of sale he executed and he continued in possession of the land as the contract was merely simulated or fictitious.

There is no contract of sale in this case as the parties do not intend to be bound at all. The sale is but a sham.

*Note:* Non-payment of the purchase price does not by itself prove that the sale is simulated. At most, it gives the vendor only the right to sue for collection. (Villaflor vs. Court of Appeals, 280 SCRA 297 [1997].) But the contract of sale is void where the buyer has in fact, paid no consideration which is stated as paid. (see Arts. 1352, 1353.) The most protuberant index of simulation of a contract of sale is the complete absence on the part of the vendee of any attempt in any manner to assert his rights of ownership over the disputed property. (Tating vs. Marcella, 519 SCRA 79 [2007].) The concept of inadequacy or non-payment of price irreconcilable with the concept of simulation. If there exists and actual consideration for transfer evidenced by the alleged act of sale, no matter how inadequate it be, the transaction could not be a "simulated sale.'' (Aliño vs. Heirs of A. Lorenzo, 556 SCRA 139 [2008].)

ILLUSTRATIVE CASE:

*Contract was entered into to circumvent the law but parties intended to be bound.*

*Facts:* In order to circumvent the prohibition against donation between husband and wife (see Art. 133.[20]) W sold her fishponds to her daughter, D who, in turn, sold the same to W and H (W's second husband and D's stepfather).

A controversy arose between W and the children of H by his first marriage. W sought to recover the fishponds.

*Issue:* Are the two conveyances simulated or fictitious?

*Held:* No. W and D intended the two conveyances to be real and effective, for W could not intend to keep the ownership of the fishponds and at the same vest half of them to her husband. The two contracts of sale then could not have been simulated, but were real and intended to be fully operative, being the means to achieve the result desired. Nor does the intention of the parties to circumvent by these contracts the law against donations between spouses make them simulated ones.

The rule in *pari delicto non oritur actio* (see Art. 1412[1].), denying recovery to the guilty parties *inter se* apply. *(Rodriguez vs. Rodriguez, 20 SCRA 928 [1967].)*

(2) *Relative simulation* or when the contract entered into by the parties is different from their true agreement[21] or the parties state a false cause in the contract to conceal their real agreement. (Art. 1345; see Arts. 1353, 1602.) The parties are bound by their real agreement, provided, it does not prejudice a third person and is not intended for a purpose contrary to law, morals, good customs, public order, or public policy. (Art. 1346.)

The *pari delicto* rule does not apply where both the object and cause are licit and the simulation is only on the content or terms thereof. (Robleza vs. Court of Appeals, 174 SCRA 354 [1989].)

When the parties intended to be bound by the contract except that it did not reflect the actual purchase of the property, there is only a

[20]Now Article 87, Family Code. (see Note 4 under Art. 1329.)

[21]Financial leases are species of secured financing. While they are complex arrangements, they cannot be casually dismissed as "simulated contracts." They are genuine and legitimate contracts which have been accorded statutory and administrative recognition in our jurisdiction. (Beltran vs. PAIC Finance Corporation, 209 SCRA 105 [1992]; see R.A. No. 3980, as amended, known as the "Financing Company Act.")

relative simulation of the contract which remains valid, but such subject to reformation. (Macapagal vs. Remoun, 458 SCRA 652 [2005].) The fact that the amount of the annual installments of the purchase price dovetails with the rate of rentals stipulated in the lease contract is not enough reason to claim that there was no consideration for the contracts of sale and lease, especially where the vendor-lessee's continued to occupy the premises after she sold it to the vendee-lessor, which continued occupancy constituted valuable consideration for the sale. To determine whether a sale-lease-back agreement is simulated, the true intention, a factual issue, of the parties, rather than the correct interpretation of the written stipulations, must be looked into. (J.R. Blanco vs. Quasha, 318 SCRA 373 [1999].)

EXAMPLES:

(1) C and D entered into a contract of mortgage. But wanting to hide the mortgage, it was made to appear in the form of a deed of sale.

Here, there are two acts involved: the ostensible act (contract of sale) and the hidden act (contract of mortgage).

As far as C and D are concerned, the contract entered into between them is a contract of mortgage. As to third persons, the apparent contract, the contract of sale, is the one entered into. Consequently, if D is the mortgagee but is made to appear as the buyer and he sells the land to B, the latter will acquire ownership. C and D are in estoppel.

(2) Under a contract of sale of a parcel of land, the seller agreed to a price lower than the true consideration stated in the deed of sale, where the buyer, despite the non-payment by him of the full purchase price, registered the deed of sale.

Under Article 1346, the parties shall be bound by their real agreement. The *pari delicto* rule does not apply as both the object and cause are licit. If the concealed contract is lawful, it is absolutely enforceable where the essential requisites are present and the simulation is only on the contents or terms thereof. (Robleza vs. Court of Appeals, *supra*.)

ILLUSTRATIVE CASE:

*Third person questioning a contract for being simulated failed to show prejudice to his right.*

*Facts:* D, a mortgage-debtor, transferred his right to redeem an extra-judicially foreclosed property to B. C, the mortgagee-purchaser, challenges the redemption on the ground that the transfer was simulated.

*Issue:* Has C the right to question the contract for being simulated in fraud of creditor?

*Held:* No. The transfer could not affect C nor cause him any damage, even assuming that it was fraudulently executed. Furthermore, no proof was presented by C to overcome the probative weight of the public document supporting the transfer. *(Gorospe vs. Santos, 69 SCRA 191 [1976].)*

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## SECTION 2. — *Object of Contracts*

**ART. 1347. All things which are not outside the commerce of men, including future things, may be the object of a contract. All rights which are not intransmissible may also be the object of contracts.**

**No contract may be entered into upon future inheritance except in cases expressly authorized by law.**

**All services which are not contrary to law, morals, good customs, public order or public policy may likewise be the object of a contract. (1271a)**

**ART. 1348. Impossible things or services cannot be the object of contracts. (1272)**

### Concept of object of a contract.

The *object of a contract* is its subject matter. (Art. 1318[2].)

In reality, the object of every contract is the obligation created. But since a contract cannot exist without an obligation, it may be said that the thing, service, or right which is the object of the obligation is also the object of the contract. (2 Castan 9.)

### Kinds of object of contract.

Object certain is the second essential element of a valid contract. *(Ibid.)* The object may be things (as in sale of property), rights (as in assignment of credit), or services (as in agency).

### Requisites of things as object of contract.

In order that things may be the object of a contract, the following requisites must be present:

(1) The thing must be within the commerce of men, that is, it can legally be the subject of commercial transaction (Art. 1347.);

(2) It must not be impossible, legally or physically (Art. 1348.);

(3) It must be in existence or capable of coming into existence (see Arts. 1461, 1493, 1494.); and

(4) It must be determinate or determinable without the need of a new contract between the parties. (Arts. 1349, 1460, par. 2.)

### Requisites of services as object of contract.

In order that service may be the object of a contract, the following requisites must concur:

(1) The service must be within the commerce of men;

(2) It must not be impossible, physically or legally (Art. 1348.); and

(3) It must be determinate or capable of being made determinate. (Arts. 1318[2], 1349.)

### Rights as object of contract.

As a general rule, all rights may be the object of a contract. The exceptions are when they are intransmissible by their nature, or by stipulation, or by provision of law. (Art. 1311, par. 1.)

EXAMPLES:

(1) *Outside the commerce of men.* — Things of public ownership such as sidewalks, public places, bridges, streets, etc.; things that are common to everybody such as air, sunlight, rain, etc.

It has been held that the rights and interests covered by a Certificate of Land Transfer issued under the Agrarian Reform Program are beyond the commerce of men. They are not negotiable except when the Certificate is used by the beneficiary as a collateral for a loan with a rural bank for an agricultural production. (Torres vs. Ventura, 187 SCRA 96 [1990].)

(2) *Impossible, physically or legally.* — Prohibited drugs and all illicit objects; to kill a person, etc. (illicit things or services are also outside the commerce of men.); to get soil from planet Jupiter; to construct a building in one day; etc.

(3) *Determinable things.* — All the cavans of rice in a warehouse; all the eggs in a basket; my land with the smallest area; the land at the corner of a particular street; etc.

(4) *Future things or rights.* — Things to be manufactured, raised, or acquired after the perfection of the contract such as wine that a vineyard is expected to produce; wool that shall thereafter grow upon a sheep; rice to be harvested next harvesting season; milk that a cow may yield; eggs that hens may lay; young animals not yet in existence, etc. (Sibal vs. Valdez, 50 Phil. 512 [1927].)

Future things include future rights. Thus, an author may assign the royalty which he expects to receive from his publisher.

(5) *Intransmissible rights.* — Political rights such as the right to vote; family, marital, and parental rights; right to public office, or to run for public office, etc.

ILLUSTRATIVE CASES:

1. *Mortgagor transferred, after foreclosure but before expiration of redemption period, his rights in favor of a third party.*

*Facts:* After the extra-judicial foreclosure by DBP (mortgagee) and sale to it of the mortgaged real estate, but within the one (1) year period for redemption, S (mortgagor) executed a "Deed of Sale with Assumption of Mortgage" over said property in favor of B under which the latter agreed to assume and pay the mortgage debt of S to DBP.

*Issue:* Under the deed, what rights were transferred to B?

*Held:* The only rights that can be transferred under the Deed are the rights: (1) to redeem the property; and (2) to possess, use, and enjoy the same during the period of redemption. *(Dizon vs. Gabarro, 83 SCRA 688 [1978].)*

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2. *Right to present one's candidacy for public office made the object of a contract.*

*Facts:* X had an agreement with Y that X would not file his certificate of candidacy for a seat in the Congress of the Philippines. Y complained on account of X's violation of the "pledge" in question.

*Issue:* Is the agreement valid?

*Held:* It is a nullity. Among those that may not be the subject matter (object) of contracts are certain rights of individuals which the law and public policy have deemed wise to exclude from the commerce of man. Among these are the political rights conferred upon citizens including, but not limited to, one's right to vote, the right to present one's candidacy to the people and to be voted to public office, provided, however, that all the qualifications prescribed by law obtain.

Such rights may not, therefore, be bargained away or surrendered for a consideration by the citizen nor unduly curtailed with impunity, for they are conferred not for individual or private benefit or advantage but for the public good and interest. *(Saura vs. Sindico, 107 Phil. 336 [1960].)*

**Meaning of future inheritance.**

*Future inheritance* is any property or right, not in existence or capable of determination at the time of the contract, that a person may inherit in the future. (Blas vs. Santos, 1 SCRA 899 [1961].)

**Requisites of inheritance to be considered future.**

A contract may be classified as a contract upon future inheritance where the following requisites concur:

(1) The succession has not yet been opened at the time of the contract;

(2) The object of the contract forms part of the inheritance; and

(3) The promissor has, with respect to the object, an expectancy of a right which is purely hereditary in nature. (J.L.T. Agro Inc. vs. Balansag, 453 SCRA 211 [2005]; Arrogante vs. Deliarte, 528 SCRA 63 [2007].)

**Validity of contracts upon future inheritance.**

Except in cases expressly authorized by law, a contract concerning future inheritance is void (Art. 1409[7].) and consequently, cannot be the source of any right nor the creator of any obligation between the parties. An "affidavit of conformity" seeking to validate or ratify a sale of future inheritance is useless and "suffers from the same infirmity." (Tanedo vs. Court of Appeals, 67 SCAD 57, 252 SCRA 80 [1996].)

The law permits contracts on future inheritance —

(1) in the case of future spouses who agree in their marriage settlements upon a regime other than the absolute community of property, they may donate to each other as much as one-fifth of their present property, but with respect to their future property, such donations shall be governed by the provisions on testamentary succession and the formalities of wills. (Art. 84, Family Code.) This means that such donations (by reason of marriage) of future property

shall take effect only in the event of death, to the extent laid down by law in testamentary succession; and

(2) in the case of partition of property by act *inter vivos* by a person (*i.e.*, owner or source of the property) to take effect upon his death. (Art. 1080; see Arroyo vs. Gerona, 58 Phil. 226 [1933].) Partition of property representing future inheritance cannot be made effective during the lifetime of the owner. (Arrogante vs. Deliarte, 528 SCRA 63 [2007].)

Future inheritance cannot be renounced. (Uson vs. Del Rosario, 92 Phil. 531 [1952].)

**Inheritance ceases to be future upon death of decedent.**

Upon the death of the deceased who is the source of the property, however, future inheritance ceases to be future and consequently, may be the object of a contract.

It is well-settled that rights by inheritance are acquired and transmitted upon the death of the *causante*. (Art. 777.) If this is so, then it must necessarily follow that it is perfectly legal for an heir — after the death of his *causante* — to enter into a contract concerning his rights, the understanding, of course, to be that the contract would be effective only if and when he is declared an heir and only as regards any property or properties that may be adjudicated to him as such. (Bough vs. Anapol, [CA] No. 2224-R, June 16, 1949; Osorio vs. Osorio, 41 Phil. 513 [1921].)

ILLUSTRATIVE CASES:

1. *Contract concerning future inheritance was ratified after death of deceased.*

*Facts:* An agreement for the partition of the estate of a living demented woman was made between those who in case of death, would be in a position to inherit the estate. After her death, the same parties entered into another agreement confirming and ratifying the partition agreement, which ratification was presented in the intestate proceedings of the deceased and approved by the court.

Some of the parties contend that since the contract of partition covering as it did a future inheritance, was void under Article 1347 (par. 2.), its ratification was also a nullity.

*Issue:* Is this contention correct?

*Held:* No. It overlooks the fact that before the deed of ratification was executed, death had removed the owner of the estate from the scene of life. This circumstance removed the cause of nullity. A mere contract cannot, of course, be ratified as long as the cause of nullity continues to exist, but when this cause is removed, the parties are free to contract as they please. Whether the second agreement be viewed as a ratification, confirmation, or a new contract, the result is the same, namely, the parties are bound by said contract unless it was vitiated by fraud, actual or constructive. *(Arroyo vs. Gerona, 58 Phil. 266 [1933];* see, however, Tañedo vs. Court of Appeals, *supra.)*

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2. *Before death of her husband, wife promised to transfer her share in the conjugal properties to husband's heirs.*

*Facts:* Before the death of her husband, H, W signed a document promising to transmit one-half of her share in the conjugal properties acquired with H, which properties are stated or declared to be conjugal properties, in the will of H, to such of H's heirs as W might choose in her last will and testament.

W was the second wife of H. She died without having complied with her promise.

*Issue:* Does the document deal with a future inheritance?

*Held:* No. The promise made by W does not refer to any properties that she would inherit upon the death of her husband. The document refers to existing properties which she will receive by operation of law on the death of her husband, because it is her share in the conjugal assets. Her promise may be enforced. *(Blas vs. Santos, 1 SCRA 899 [1961].)*

### Kinds of impossibility.

Impossibility may be:

(1) *Physical.* — when the thing or service in the very nature of things cannot exist (*e.g.*, a monkey that talks) or be performed. With particular reference to services (see Arts. 1266, 1267.), the impossibility may be:

(a) *Absolute.* — when the act cannot be done in any case so that nobody can perform it (*e.g.*, to fly like a bird, etc.); or

(b) *Relative.* — when it arises from the special circumstances of the case (*e.g.*, to make payment to a dead person, to drive a car on flooded highways, etc.) or the special conditions or qualifications of the obligor (to paint a portrait by a blind person, etc.); or

(2) *Legal.* — when the thing or service is contrary to law, morals, good customs, public order, or public policy. An act is contrary to law, either because it is forbidden by penal law (*e.g.*, to sell prohibited drugs, etc.) or a rule of law makes it impossible to be done (*e.g.*, to make a valid donation of real property without a public instrument [Art. 749.], to make a valid will, where the testator is under 18 years of age [Art. 797.], etc.).

**Effect of physical impossibility on validity of contract.**

(1) The absolute impossibility nullifies the contract.

(2) The relative impossibility, if temporary, does not nullify the contract, such as when a partner agrees to contribute to the partnership an amount more than is permissible by his means; if permanent, it annuls the contract, such as blindness in contracts which require the use of eyesight. (8 Manresa 685.)

**ART. 1349. The object of every contract must be determinate as to its kind. The fact that the quantity is not determinate shall not be an obstacle to the existence of the contract, provided it is possible to determine the same, without the need of a new contract between the parties. (1273)**

**Quantity of object of contract need not be determinate.**

The object of a contract must be determinate as to its kind or at least determinable without the necessity of a new or further agreement between the parties. It need not be specified with absolute certainty. The same is true of the quantity of the object of the contract. It is sufficient that it is possible to determine the same without the need of a new contract between the parties.[1]

When the obligation consists in the delivery of a generic thing, whose quality and circumstances have not been stated, Article 1246 governs.

[1]Art. 1460. A thing is determinate when it is particularly designated or physically segregated from all others of the same class.

The requisite that a thing be determinate is satisfied if at the time the contract is entered into, the thing is capable of being made determinate without the necessity of a new or further agreement between the parties. (n)

EXAMPLES:

(1) S sold to B all the chickens in his poultry. Here, the object itself (chickens) is determinate but the quantity though not yet determined can be ascertained without the necessity of entering into a new contract.

(2) S agreed to deliver one of his carabaos to B. Here, the object is determinable without the need of a new contract between the parties. It becomes determinate the moment it is delivered.

(3) If the subject matter of the agreement is a parcel of agricultural land owned by S and S happens to own many agricultural lands, the contract is void, if the particular land sold cannot be determined without a new or further agreement between the parties.

(4) S obligates himself to sell to B for a price certain (P3,000.00) a specified quantity of sugar (200 kilos) of a given quality (of the first grade and second grade) without designating a particular lot of sugar.

The contract is not perfected until the quantity agreed upon has been selected and is capable of being physically designated and distinguished from all other sugar. (Yu Tek Co. vs. Gonzales, 29 Phil. 348 [1915]; De Leon vs. Aquino, 87 Phil. 193 [1950].)

In this case, the contract is merely an executory contract of sell. The promise of S is to deliver a generic thing which is determinable. The moment it is delivered, it becomes determinate.

(5) S binds herself to deliver a "thing" or "property" to B. The contract is void because the object is "not determinate as to its kind" nor is it "capable of being made determinate without the need of a new or further agreement between the parties." (Art. 1460.)

ILLUSTRATIVE CASE:

*The parties failed to draw a parcelary plan of the portions of the hacienda to be leased as provided in the contract.*

*Facts:* A leased 80 hectares of his 150 hectare *pro indiviso* share in an hacienda to J. Subsequently, A cancelled the lease contract because of J's failure, *inter alia,* to attach thereto the parcelary plan identifying the exact area subject of the agreement, duly marked and to be initiated by the parties as an integral part of the contract, as stipulated therein.

In A's answer to J's complaint in the lower court, A asserted that the "the plaintiff [J] must deliver his work to the area previously designated and delivered." Asked during the trial how many hectares J actually occupied, A declared: "About 80 hectares. The whole 80 hectares."

*Issue:* Was there an agreed subject matter?

*Held:* Yes. The 80 hectares of A's share in the hacienda, although it was not expressly defined because the parcelary plan was not annexed and never approved by the parties. Despite this lack, however, there was an ascertainable object because the leased premises were sufficiently identified and delineated as A admitted in his answer and in his direct testimony. A cannot contradict his written and oral admissions. *(Azcona vs. Jamandre, 151 SCRA 317 [1984].)*

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## SECTION 3. — *Cause of Contracts*

**ART. 1350. In onerous contracts the cause is understood to be, for each contracting party, the prestation or promise of a thing or service by the other; in remuneratory ones, the service or benefit which is remunerated; and in contracts of pure beneficence, the mere liberality of the benefactor. (1274)**

### Meaning of cause.

*Cause (causa)* is the essential or more proximate purpose or reason which the contracting parties have in view at the time of entering into the contract (see 8 Manresa 697; Republic vs. Cloribel, 36 SCRA 534 [1970].) or, as expressed in another case, it is the "why of the contract, the essential reason which moves the contracting parties to enter into the contract." (Gonzales vs. Trinidad, 67 Phil. 682 [1939]; Villamor vs. Court of Appeals, 202 SCRA 607 [1991]; Domingo vs. Court of Appeals, 367 SCRA 368 [2001].)

It is the Civil Code term for *consideration* in Anglo-American or common law.

### Distinguished from the English doctrine of consideration.

The terms "cause" and "consideration" are used interchangeably but there is an essential difference between the two.

According to its accepted meaning in common law, consideration may consist either in some legal right, interest, benefit or advantage conferred upon the promissor, to which he is otherwise not lawfully entitled, or in some legal detriment, prejudice, loss or disadvantage suffered or undertaken by the promisee other than to such as he is at the time of consent bound to suffer. (Olegario vs. Court of Appeals, 238 SCRA 96 [1994].)

The doctrine of consideration developed by the English courts is narrower than the continental doctrine of *causa.* While cause includes every valuable consideration in the Anglo-American sense, many agreements which cannot be supported in English law for want of consideration can be enforced under the broader doctrine of *causa.* (see Lorenzen, Selected Readings on the Law of Contracts, pp. 565, 579, 581-582, cited in G. Florendo, The Law of Obligations and Contracts [1936], pp. 706-707.)

Unlike the English principle, the continental doctrine never rejects any cause or consideration as insufficient. Whatever inducement is enough to satisfy the contracting parties, is enough to satisfy the law. (see Salmond, Jurisprudence [7th Ed.], pp. 371, 372, 375, cited in G. Florendo, *supra,* p. 707.) Thus, a subsequent promise by X to reimburse Y for a past service or benefit conferred on X but not at the instance of X, would be sufficient *causa* but would not constitute sufficient consideration in the sense of the common law. Similarly, mere liberality of the benefactor constitutes *causa* in a contract of pure beneficience but does not furnish sufficient consideration under the English doctrine to make the promise enforceable.

**Cause distinguished from object.**

In a bilateral or reciprocal contract like purchase and sale, the cause for one is the subject matter or object for the other, and *vice versa.* Hence, the distinction is only a matter of viewpoint.

EXAMPLE:

S sells a watch to B for P2,000. As far as S (vendor) is concerned, the subject matter or object is the watch and the cause is the price. As regards B (vendee), the subject matter or object is the price and the cause is the watch.

A school of thought, however, makes these distinctions. The cause for S is the delivery of the price and for B, the delivery of the watch. But to both S and B, the subject matter of the transaction is the watch. (see IV Tolentino, Civil Code, 1973 Ed., p. 501.)

**Classification of contracts according to cause.**

They are:

(1) *Onerous* or one the cause of which, for each contracting party, is the prestation or promise of a thing or service by the other. In other

words, in this contract, the parties are reciprocally obligated to each other.

(a) The cause as to one party need not be adequate or of equivalent value with that of the other except where the marked disparity in value may, in combination with other circumstances, indicate fraud, mistake, or undue influence. (see Art. 1355.) A valuable consideration, however, small or nominal, if given or stipulated in good faith is, in the absence of fraud, sufficient. (Penaco vs. Ruaya, 110 SCRA 46 [1981].)

(b) A purely moral obligation cannot constitute a sufficient cause to support an onerous contract (Fischer vs. Robb, 69 Phil. 101 [1939].) but a natural obligation is a sufficient cause to sustain such contract. (see Villareal vs. Estrada, 71 Phil. 140 [1940].)

(c) In an accessory contract (like mortgage), the cause is the very cause of the principal contract from which it receives its life and without which it cannot exist as an independent contract. (China Banking Corp. vs. Lichauco, 46 Phil. 460 [1924].)

(d) In a case, the petitioners would contribute property to the partnership in the form of land which was to be developed into a subdivision, while respondent would give, in addition to his industry, the amount needed for general expenses and costs, and the income from the said project would be divided according to the stipulated percentage. Here, the cause of the contract of sale in favor of the respondent by the petitioners who did not actually receive payment consisted not in the stated peso value of the land but in the expectation of profits from the subdivision project for which the land was intended to be used (Torres vs. Court of Appeals, 320 SCRA 428 [1999].);

(2) *Remuneratory* or *remunerative* or one the cause of which is the service or benefit which is remunerated. The purpose of the contract is to reward the service that had been previously rendered by the party renumerated; and

(3) *Gratuitous* or one the cause of which is the mere liberality of the benefactor or giver, such as commodatum; pure donation; guaranty or suretyship unless there is a stipulation to the contrary (Art. 2048.), mortgage given by a third person to secure an obligation of a debtor (see Art. 2085, last par.) unless a consideration is paid for such mortgage.

ILLUSTRATIVE CASES:

1. *Contract is that plaintiff would receive property after being allowed to live with defendant.*

*Facts:* B and E signed a document which in effect stated that if the girl, T, was allowed to live with them, and she (T) should marry or leave them, or if they (B and E) should die, she would receive one-half of their property. It appeared that T accepted the stipulation. (see Art. 1311.) T later married and left B and E.

*Issue:* Should the contract be given effect?

*Held:* Yes. While the case presents a somewhat unusual situation, there is no legal reason for not giving effect to the contract. The document is in the nature of a contract. More accurately speaking, it is a donation *con causa onerosa,* which means that it is governed by the provisions of the Civil Code relating to contracts. *(Tabar vs. Becada and Endab, 44 Phil. 619 [1923].)*

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2. *Promise to make reimbursement was prompted by feeling of moral responsibility.*

*Facts:* The enterprise Philippine Greyhound Club, Inc., which was formed to introduce dog racing in the Philippines did not succeed. X, one of the organizers, wrote a letter to Y, one of those who invested money in the venture, stating that he felt a "moral responsibility" for the stockholders and that he will see to it that those who had made the second payment of P2,000.00 of their subscription "shall be reimbursed such amount as soon as possible out of his own personal funds."

X brought action against Y to enforce the promise.

*Issue:* Is there a sufficient cause to support the promise of A?

*Held:* None. X is required to pay P2,000.00 but Y has not given or promised any thing or service to X which may compel him to make such payment. The promise of X was prompted by a feeling of pity which X had for Y as a result of the loss which the latter had suffered because of the failure of the enterprise. The obligation which X had contracted with Y is, therefore, purely moral, and, as such, is not demandable in law but only in conscience over which human judges have no jurisdiction. *(Fisher vs. Robb, 69 Phil. 101 [1939].)*

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3. *Promise to pay refers to an obligation of promissor's mother which has already prescribed.*

*Facts:* X entered into contract with Y by virtue of which X undertook to pay Y a certain debt of X's mother to the parents of Y more than 18 years ago, which debt had already prescribed.

Y brought action against X to enforce the contract.

*Issue:* Is there a sufficient cause to support the contract of X?

*Held:* Yes. The action of Y is not founded on the original obligation of X's mother, which had already prescribed, but on that contracted by X, in assuming the obligation of his mother. X, being the only heir of the original debtor with the right to succeed in her inheritance, that debt lawfully contracted by his mother although it lost its efficacy by prescription, is nevertheless now a moral obligation as far as he is concerned, a moral obligation[1] which is sufficient consideration to create and make effective and demandable the obligation which he had voluntarily contracted. *(Villareal vs. Estrada, 71 Phil. 140 [1940].)*

## Liberality as cause in contracts of beneficence.

Under Article 1350, the liberality of the benefactor is deemed *causa* only in those contracts that are of *pure* beneficence, that is to say, contracts designed solely and exclusively to procure the welfare of the beneficiary, without any intent of producing any satisfaction for the donor; contracts, in other words, in which the idea of self-interest is totally absent on the part of the transferor.[2]

In line with the above view, bonuses granted to employees to excite their zeal and efficiency, with consequent benefit to the employer, do not constitute donation having liberality for a consideration. (Phil. Long Distance Tel. Co. vs. Jeburian, 97 Phil. 981 [1955]; see Liguez vs. Court of Appeals, 102 Phil. 577 [1957].)

**ART. 1351. The particular motives of the parties in entering into a contract are different from the cause thereof. (n)**

[1]The court really means a natural obligation. (see Arts. 1423, 1424.)

[2]A person who occupies the land of another at the latter's tolerance or permission, without any contract between them is necessarily bound by an implied promise that he will vacate upon demand, failing which a summary action for ejectment is the proper remedy against him. (Roxas vs. Court of Appeals, 391 SCRA 351 [2002].)

**Meaning of motive.**

*Motive* is the purely personal or private reason which a party has in entering into a contract. It is different from the cause of the contract.

Article 1351 embodies "a principle which is common to both Philippine law and American jurisprudence." (Report of the Code Commission, p. 137.)

**Cause distinguished from motive.**

As contradistinguished from consideration or cause, motive has been defined as the condition of mind which incites to action, but includes also the inference as to the existence of such condition from an external fact of a nature to produce such a condition. (Olegario vs. Court of Appeals, 238 SCRA 96 [1994].)

The differences are as follows:

(1) Cause is the immediate or direct reason, while motive is the remote or indirect reason;

(2) Cause is always known to the other contracting party, while motive may be unknown;

(3) Cause is an essential element of a contract, while motive is not; and

(4) The illegality of the cause affects the validity of a contract, while the illegality of one's motive does not render the contract void.

In other words, cause is the essential reason which moves the contracting parties to enter into it and justifies the creation of an obligation through their will. While cause is the essential reason for the contract, motive is the particular reason of a contracting party which does not affect the other party. (Uy vs. Court of Appeals, 314 SCRA 69 [1999].)

**When motive regarded as cause.**

As a general principle, the motive or particular purpose of a party in entering into a contract does not affect the validity nor existence of the contract. (Phil. National Construction Corp. vs. Court of Appeals, 272 SCRA 183 [1997].)

Under certain circumstances, the motive may be considered the cause in a contract when such motive predetermines the cause of the contract (Liguez vs. Court of Appeals, *supra*; Republic vs. Cloribel,

36 SCRA 534 [1970].), *i.e.*, it is made the condition for the efficacy of the contract, or is founded on a fraudulent purpose to prejudice third persons. When they blend to that degree, and the motive is unlawful, then the contract entered into is null and void under Article 1352. (see Olegario vs. Court of Appeals, *supra.*)

EXAMPLES:

(1) S sells his house and lot to B for One (1) million pesos. For S, the cause or consideration is the One (1) million pesos. But his motive or private reason may be to use the money in business or to buy another house.

The motives which impel one to a sale or purchase are not always the cause of the contract as that term is understood in law. With one's motives, the law cannot deal in actions between the parties; while with the consideration, the law is always concerned. (De Jesus vs. Urrutia & Co., 33 Phil. 171 [1916].)

(2) If the motive of S in selling his property is to defraud C, a creditor, the latter may ask for the rescission of the sale. (see Arts. 1381[3], 1387.)

(3) W (wife) died. To preclude her heirs from inheriting and to avoid payment of estate taxes, H (spouse) sold the conjugal property to B. The sale cannot prejudice the inheritance right of the heirs to their share of the conjugal property. Here, the illegal motive of H predetermined the purpose of the contract of sale rendering it null and void. (Olegario vs. Court of Appeals, *supra.*)

ILLUSTRATIVE CASES:

1. *Donation was impelled by donor's desire to cohabit with donee.*

*Facts:* R donated a parcel of land to E. R was impelled to make the donation because of his desire for cohabiting with E. E claimed that the cause of the contract was the liberality of R and that the motive of E (*i.e.*, to cohabit with her) was different from such cause and, therefore, the donation was valid.

*Issue:* Is this contention tenable?

*Held:* No. The motive may be regarded as the cause when it predetermines the cause of the contract. It was not disputed that R would not have conveyed the property in question had he known that E would refuse to cohabit with him; so that cohabitation was an implied condition of the donation, and being unlawful, necessarily tainted the donation itself.

The contract was onerous in character. It was clearly predicated upon an illicit cause. *(Liguez vs. Court of Appeals, 102 Phil. 577 [1957].)*

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2. *The transfer of shares was motivated by the purpose to obtain a contract with the government.*

*Facts:* Under the Anti-Graft and Practices Act (Sec. 5, R.A. No. 3019.), AR, by reason of his relationship with then President of the Philippines (being brothers-in-law), was prohibited from intervening, directly or indirectly, in any transaction or business with the government.

Through persons fronting for him, AR acquired from ER 60% of equity of ER, Inc. Thus, ER, Inc. was in fact controlled by AR, though ostensibly owned by ER who transferred the shares to be able to renew, though the influence of AR, his management contract with the Philippine Ports Authority (PPA) to operate the arrastre service in all the ports at the Manila South Harbor. The management contract was as expected, renewed by the PPA.

*Issue:* Is the management contract valid?

*Held:* No. The transfer of the shares of stock of ER, Inc. to persons fronting for AR was null and void. The invalidity springs not from vitiated consent or absolute want of monetary consideration, but for its having had an unlawful cause — that of obtaining a government contract in violation of law.

While the general rule is that the *causa* of the contract must not be confused with the motives of the parties, this case squarely fits into the exception that the motive may be regulated as *causa* when it predetermines the purpose of the contract. On the purpose of AR, his motive was to be able to contract with the government which he was then prohibited by law from doing, and on ER's part, to be able to renew his management contract, for ER would not have transferred said shares of stock to AR without an assurance from the latter that he would be unduly favored with a renewal of the contract.

The management contract being the direct result of a previous illegal contract (the transfer of the shares) is itself null and void under Article 1422.

A party is deemed a participant in an unlawful intention where he knows and intends that the subject matter will be used for an illegal purpose. It is not necessary that he derives any benefit from the unlawful use of the subject matter. It is sufficient that, with knowledge of the unlawful purpose, he does anything which facilitates the carrying out of such purpose.

Therefore, ER's attempt to associate or divorce himself from the illegality of the transfer and, consequently, of the management contract, as well as his claim of innocence or being a victim of the previous regime, must fail. *(E. Razon, Inc. vs. Philippine Ports Authority, 151 SCRA 233 [1987].)*

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3. *The National Housing Authority cancelled the sale to it of certain parcels of land because they were found not suitable for its housing project.*

*Facts:* Petitioners A and B, agents, sold eight (8) parcel of lands of their principals to National Housing Authority (NHA) to be utilized and developed as a housing project. Subsequently, NHA cancelled the sale over three (3) parcels of land because they were not suitable for housing as NHA claimed.

*Issue:* Has NHA the right to cancel the sale?

*Held:* Yes. (1) *Contract was cancelled, not rescinded.* — "In this case, NHA did not rescind the contract. Indeed, it did not have the right to do so for the other parties to the contract, the vendors, did not commit any breach, much less a substantial breach, of their obligation. Their obligation was merely to deliver the parcels of land to the NHA, an obligation that they fulfilled. The NHA did not suffer any injury by the performance thereof. The cancellation, therefore, was not a rescission under Article 1191. Rather, the cancellation was based on the negation of the cause arising from the realization that the lands, which were the object of the sale, were not suitable for housing."

(2) *Distinctions between cause and motive.* — "Cause is the essential reason which moves the contracting parties to enter into it. In other words, the cause is the immediate, direct and proximate reason which justifies the creation of an obligation through the will of the contracting parties. Cause, which is the essential reason for the contract, should be distinguished from motive, which is the particular reason of a contracting party which does not affect the other party.

For example, in a contract of sale of a piece of land, such as in this case, the cause of the vendor (petitioner's principals) in entering into the contract is to obtain the price. For the vendee, NHA, it is the acquisition of the land. The motive of the NHA, on the other hand, is to use said lands for housing. This is apparent from the portion of the Deeds of Absolute Sale. x x x"

(3) *Cancellation was justified.* — "In this case, it is clear, and petitioners do not dispute, that NHA would not have entered into the contract were the lands not suitable for housing. In other words, the quality of the lands

was an implied condition for the NHA to enter into the contract. On the part of the NHA, therefore, the motive was the cause for its being a party to the sale. x x x

According, we hold that the NHA was justified in cancelling the contract. The realization of the mistake as regards the quality of the land resulted in the negation of the motive/cause thus rendering the contract inexistent. (see Art. 1318.) The contract is also voidable under Article 1331." *(Uy vs. Court of Appeals, 314 SCRA 69 [1999].)*

**ART. 1352. Contracts without cause, or with unlawful cause, produce no effect whatever. The cause is unlawful if it is contrary to law, morals, good customs, public order or public policy. (1275a)**

### Requisites of cause.

The following are the requisites of cause:

(1) It must exist at the time the contract is entered into (Arts. 1352, 1409[3].);

(2) It must be lawful *(Ibid.)*; and

(3) It must be true or real. (Art. 1353.)

### Effect of absence of cause.

*Absence* or *want of cause* means that there is a total lack of any valid consideration for the contract. (see Garanciang vs. Garanciang, 28 SCRA 229 [1969].)

(1) *Statement in contract of a non-existent cause.* — Contracts without cause confer no right and produce no legal effect whatever. Thus, a contract which is absolutely simulated or fictitious is inexistent and void. (Arts. 1346, 1409[3].) Where there is, in fact, no consideration, the statement of one in the contract will not suffice to bring it under the rule of Article 1353 as stating a false consideration. (Mapalo vs. Mapalo, 17 SCRA 114 [1966].)

A contract of sale, for example, is void if the price is simulated, but the act may be shown to have been in reality a donation or some other act or contract. (Art. 1471.)

(2) *Grant of right of first refusal.* — It is not correct to say that there is no consideration for the grant of the right of first refusal if such grant is embodied in the same contract of lease. Since the stipulation forms

part of the entire lease contract the consideration for the lease includes the consideration for the grant of the right of first refusal. In entering into the contract, the lessee is, in effect, stating that it consents to lease the premises and to pay the price agreed upon provided the lessor also consents that should the lessor sell the leased property, then, the lessee shall be given the right to match the offered price and to buy the property at that price. In other words, the rent paid by the lessee constitutes sufficient consideration for the grant of a right of first refusal. (Equitorial Realty Development, Inc. vs. Mayfair Theater, Inc., 264 SCRA 483 [1996]; Lucrative Realty Development Corporation vs. Bernabe, Jr., 392 SCRA 679 [2002].)

ILLUSTRATIVE CASES:

1. *Supposed buyer could not have made the purchase for not having any means of livelihood.*

*Facts:* The administrator of the estate of D brought an action against C, etc., heirs of B, to declare null and void a deed of sale purportedly executed by D in favor of B for P700.00. When the deed of sale was executed (on January 17, 1941), D was almost 100 years old and was in a weak condition. B did not have any means of livelihood. He was only the houseboy of D.

*Issue:* Is the sale valid?

*Held:* No. "It is obvious that on January 17, 1941, B could not have raised the amount of P700.00 as consideration of the land supposedly sold to him by D." The deed of sale is void and inexistent for lack of consideration. (*Javier vs. Cruz, 80 SCRA 343 [1977];* see Carantes vs. Court of Appeals, 76 SCRA 514 [1977], under Art. 1410.)

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2. *Supposed deed of sale was proven to be an equitable mortgage.*

*Facts:* A deed of sale with *pacto de retro* contains a stipulation that B (vendee *a retro)* shall be given by S (vendor *a retro)* the first opportunity to buy the land at P1,500.00 per hectare. The deed was declared by the court as an equitable mortgage.[3]

[3]Art. 1602. The contract shall be presumed to be an equitable mortgage, in any of the following cases:

(1) When the price of a sale with right to repurchase is unusually inadequate; x x x x x x

(6) In any other case where it may be fairly inferred that the real intention of the parties is that the transaction shall secure the payment of a debt or the performance of any other obligation.

*Issue:* Is the stipulation valid?

*Held:* No. It follows as a legal consequence that the land was constituted as a mortgage or security for the loan obtained by S from B. In other words, the consideration for such mortgage was the loan secured from B, the mortgagee. The mortgage being merely an accessory to the principal obligation of S, there is no other consideration for the stipulation inserted in the deed of sale with *pacto de retro. (Gardner vs. Court of Appeals, 80 SCRA 399 [1977].)*

It has been held that where a conveyance of part of an estate was made by the heirs to save the estate from a possible litigation in court, said conveyance was for a valid and valuable consideration. (Aquino vs. Esguerra, 87 Phil. 396 [1950].) Where the stipulation for a right of first refusal is part and parcel of the contract of lease, the consideration for the right is built into the reciprocal obligations of the parties. The right stands upon a valuable consideration and can be enforced according to its terms. *(Polytechnic University of the Phils. vs. Court of Appeals, 368 SCRA 691 [2001].)*

### Effect of failure of cause.

Absence of cause should be distinguished from *inadequacy of cause* which, as a general rule, is not a ground for relief (see Art. 1355.), and from *failure of cause* which does not render a contract void. (see Arts. 1169, par. 3; 1170, 1191.)

(1) The failure to pay the stipulated price after the execution of a contract of sale does not convert the contract into one without cause or consideration, it not being essential to the existence of cause that payment or full payment be made at the time of the contract. (Puato vs. Mendoza, 64 Phil. 417 [1937]; Catangcatang vs. Legayada, 84 SCRA 51 [1978].) Neither is a deed of sale with a right of repurchase rendered void by the dishonor of the checks that were issued for the redemption of the properties involved by the drawee bank for having been drawn against a closed account. (Mate vs. Court of Appeals, 290 SCRA 463 [1998].)

But a contract of sale is null and void for being without cause (Art. 1409[3].) where the purchase price, *which appears thereon as paid* (*e.g.*, where the deed of sale states: that I [seller] for and in consideration

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In any of the foregoing cases, any money, fruits, or other benefit to be received by the vendee as rent or otherwise shall be considered as interest which shall be subject to the usury laws. (n)

of P50,000, to me in hand paid by B [buyer] receipt of which is hereby acknowledged) has in fact never been paid by the buyer to the seller. (Mapalo vs. Mapalo, 17 SCRA 114 [1966].) This is not merely a case of failure to pay the purchase price which can only amount to a breach of obligation with rescission as the proper remedy. There is a purported contract that lacks a cause — one of the three essential requisites of a valid contract.

Failure to pay the consideration is different from lack of consideration. The former results in a right to demand the fulfillment or cancellation of the obligation under an existing valid contract while the latter prevents the existence of a valid contract. (Montecillo vs. Reynes, 385 SCRA 244 [2002]; Macasaet vs. R. Transport Corporation, 535 SCRA 503 [2007].)

(2) Where a lending bank took over the management of the borrowing corporation, as one of the conditions for the granting of the loan, and the corporation was led to bankruptcy thru mismanagement and misappropriation of funds, thereby defeating the very purpose of the loan, it is as if the loan was never delivered and thus, there was a failure of consideration on the part of the bank.[4] (Rosa Packing Corp., Inc. vs. Court of Appeals, 167 SCRA 309 [1988].)

(3) Where the records do not show the total costs of the condominium units in question and the payment schemes therefor, and the figures referred to by the buyers as prices are mere estimates given to them by the seller of the rights to said units, the transactions lack the requisites essential for the perfection of contracts. (Raet vs. Court of Appeals, 295 SCRA 677 [1998].)

ILLUSTRATIVE CASES:

1. *Effect of a bilateral promise to sell and buy.*

*Facts:* Under a written contract, S promised to sell his hacienda to B as soon as the same could be registered. B promised to pay P70,000.00 therefor in accordance with the terms of the contract. After the issuance of the torrens title, S refused to sell the whole of the hacienda tendering only a portion thereof.

S contended, among others, that the contract was without consideration.

[4]The contract of loan is a bilateral contract. The promise to pay is the consideration for the obligation to grant the loan.

*Issue:* Is this contention meritorious?

*Held:* No. A promise made by one party, if made in accordance with the forms required by law, may be a good consideration *(causa)* for a promise made by another.[5] In other words, the consideration *(causa)* need not pass from one to another at the time the contract is entered into or the promise is made. Of course, S cannot enforce a compliance with the contract and require B to pay until he (S) has complied with his part of the contract. (*Enriquez de la Cavada vs. Diaz, 37 Phil. 985 [1918];* see Rodriguez vs. Rodriguez, 20 SCRA 908 [1967]; Phil. Banking Corp. vs. Lui She, 21 SCRA 52 [1967]; Quirino vs. Palarca, 29 SCRA 1 [1969].)

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2. *Effect of breach by seller of warranty of title to property sold.*

*Facts:* S sold certain property to B. The money paid by B was given by C. It appeared later that the property belonged to D who brought action and obtained judgment for the possession and ownership of the property.

C sought to recover the amount paid by B.

*Issues:* Does the fact that S was not owner of the property constitute lack of consideration?

*Held:* No. A simple failure of title to property conveyed gives rise to an action for breach of warranty of title under Articles 1495[6] and 1547[7] of the Civil Code and does not make a case of want of cause under Article 1352. *(Levy vs. Johnson, 4 Phil. 643 [1905].)*

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3. *Consideration of accessory contract of mortgage is that of the principal contract.*

*Facts:* R mortgaged his property to secure the debt of D in favor of C. R did not receive anything from the transaction. As D failed to pay, C sought to foreclose the mortgage.

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[5]Art. 1479. A promise to buy and sell a determinate thing for a price certain is reciprocally demandable.

An accepted unilateral promise to buy or to sell a determinate thing for a price certain is binding upon the promissor if the promise is supported by a consideration distinct from the price. (1451a)

[6]Art. 1495. The vendor is bound to transfer the ownership of and deliver, as well as warrant the thing which is the object of the sale. (1461a)

[7]Art. 1547. In a contract of sale, unless a contrary intention appears, there is:

(1) An implied warranty on the part of the seller that he has the right to sell the thing at the time when the ownership is to pass, and that the buyer shall from that time have and enjoy the legal and peaceful possession of the thing. x x x"

*Issue:* May R avoid the mortgage for lack of consideration considering that the debt secured is not his own?

*Held:* No. The consideration of a mortgage, which is an accessory contract, is that of the principal contract, from which it receives its life, and without which it cannot exist as an independent contract, even if the obligation thereby secured is of a third person[8] and, therefore, it will be valid, if the principal one is valid. *(China Banking Corp. vs. Lichauco, 46 Phil. 460 [1924].)*

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4. *Consideration of accommodation instrument is value received by accommodated party.*

*Facts:* M signs a joint and several promissory note for the accommodation of D, co-maker, in favor of C who advanced the face value of the note to D at the time of the creation of the note.

*Issue:* What is the consideration of the note as regards both makers?

*Held:* It is the money so advanced to D as the accommodated party; and it cannot be said that the note is lacking in consideration as to M, the accommodating party, because he himself received none of the money. It is enough that value be given for the note at the time of its creation. (*Acua vs. Veloso and Xavier, 50 Phil. 241 [1927]*; see Act No. 2031 [The Negotiable Instruments Law], Sec. 29.)

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5. *Consideration for deed of transfer was a non-existent liability.*

*Facts:* X and Y deposited their valuables in a dugout belonging to Z, a barrio lieutenant, upon receiving news that the Japanese forces were closing in and were committing barbarous acts. A month later, Y discovered that his money and valuables were missing. X was arrested and was released only after consenting to acknowledge his liability for the loss and executing a deed of transfer whereby X paid to Y P500.00 and further promised to transfer his land to Y in case he failed to pay for the balance of the loss.

X brought action to annul the deed of transfer.

*Issue:* Is the document valid?

*Held:* No. There was no deposit proven. Even if Y's theory of deposit were sustained, any obligation arising therefrom was extinguished upon

[8]Art. 2085. x x x Third persons who are not parties to the principal obligation may secure the latter by pledging or mortgaging their own property. (1857)

the loss without the fault of the depositee (X) and under circumstances which at the time were inevitable (Art. 1262 in connection with Arts. 1972 and 1174.), of the things already deposited.

The evidence showed that X was not in any way responsible for the loss of Y's money and jewelry. Hence, the deed of transfer is null and void for lack of cause or consideration. It also appeared that the consent of X was obtained through duress and intimidation. *(Obejera and Intak vs. Iga Sy, 76 Phil. 580 [1946].)*

**Effect of illegality of cause.**

*Illegality of cause* implies that there is a cause but the same is unlawful or illegal.

The cause is unlawful if it is contrary to law, morals, good customs public order, or public policy. (see Art. 1306.) Contracts with unlawful cause are also null and void. (Arts. 1353, 1409[1]; see Arts. 1411, 1412, 1414, 1416-1422.)

(1) A promise of marriage based upon carnal connection is founded on an unlawful cause and, therefore, void and no action can be maintained by the woman against the man therefor. (Batarra vs. Marcos, 7 Phil. 156 [1906].)

(2) A proscription against sale of property between spouses applies even to common law relationships (Calimlim-Canullas vs. Fortun, 129 SCRA 675 [1984].) The sale made by a husband in favor of concubine after he had abandoned his family and left the conjugal home is null and void, being subversive of the stability of the family which public policy cherishes and protects. (Ching vs. Goyanko, Jr., 506 SCRA 735 [2006].)

(3) A contract whereby a person accused of a crime obliges himself to give a sum of money in consideration of the promise on the part of the obligee to refrain from testifying against him is void because the purpose is to stifle criminal prosecution and this is against public policy. (Velez vs. Ramas, 40 Phil. 787 [1920]; Arroyo vs. Bernin, 36 Phil. 386 [1917].)

(4) A promissory note is *void ab initio* and no cause of action for collection can arise from it where the consideration for it is to influence public officers in the performance of their duties which is contrary to law and public policy. (Pineda vs. De la Rama, 121 SCRA 671 [1983]; see Arts. 1306, 1412[1].)

ILLUSTRATIVE CASES:

1. *Consideration of a promissory note was a pre-existing debt.*

*Facts:* For failure of A (agent) to return the P1,000.00 which P (principal) gave to A for the purchase of palay, within 10 days, if not spent for said purpose, P accused A of estafa. Later, P agreed to the dismissal of the estafa case in consideration of the execution by A of a promissory note for the amount involved. A still failed to pay the note.

P brought action for the recovery of P1,000.00. A contends that the note is void because the consideration is the dismissal of the estafa case.

*Issue:* Is the contention of A tenable?

*Held:* No. A received P1,000.00 from P for the purchase of palay. The cause or consideration, therefor, for the promise of A was his pre-existing debt, not the dismissal of the estafa case, which merely furnished the occasion for the execution of the promissory note. (*Mactal vs. Melegrito, 1 SCRA 763 [1961];* see Basic Books, Inc. vs. Lopez, 16 SCRA 291 [1966].)

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2. *Execution of a promissory note does not appear to have been specifically made in consideration of the withdrawal of a complaint for estafa.*

*Facts:* A complaint for estafa was filed by C against D in the fiscal's office. Later, C accepted a promissory note signed by D, as principal, and G, as guarantor *in solidum,* for P2,000.00, the amount for which C was allegedly swindled by D. Because of G's signature, C "withdrew his complaint and the case against D was dropped." C did not deal with G prior to, or at the time of the execution of the promissory note.

G testified that it was D who asked him to sign the promissory note; that *he did not even* know that a complaint for estafa had been filed against D who merely advised him that he (D) had "certain obligations in favor of C and that he (D) *wanted to have an extension of time* within which to pay it," and that he signed the note because he thought he could thereby help D.

*Issue:* Is the consideration for the execution of the promissory note illegal?

*Held:* No. It does not appear from the circumstances that the note was made in consideration of C's promise or obligation either to withdraw his complaint for estafa, or not to prosecute him, or not to testify against him, or to suppress any evidence against him, or otherwise to interfere with the proper administration of justice. That no such undertaking existed or was the cause for the execution of the note is more apparent from the above testimony of G.

> The undisputed obligation of D to refund to C the sum of P2,000.00 is sufficient consideration for the execution of the note and as G's testimony suggests, was his only consideration. The circumstance that because of G's signature on the note C "withdrew" his complaint and the case against D was "dropped," does not alter the situation materially. (*Garrido vs. Cardenas, 103 Phil. 435 [1958];* see also Hibberd vs. Rhode and McMillan, 32 Phil. 476 [1915].)

*Note:* In the *Garrido* case, the Supreme Court ruled as not in point the cases cited by G *(infra.)* in support of his claim that the consideration for the note was illegal.

In *Arroyo vs. Berwin* (36 Phil. 386 [1917].), the contract specifically provided that *one of the obligations contracted* thereby was "that the plaintiff would ask the prosecuting attorney to dismiss the proceedings against [the accused] for the crime for theft."

No such obligation has been contracted in the *Garrido* case.

The cause of action in *Veles vs. Ramas* (40 Phil. 787 [1920].) was based upon a contract stating that it had been entered into "in order to prevent [the offender] from being brought before the courts for the unlawful acts she has executed" and the offended parties therein *agreed* "to suspend the action they intend to bring against [her]," so that in the words of the Supreme Court "the purpose of the contracting parties was to prevent a prosecution for crime; and the injured parties on their part, agree to suspend the criminal proceedings which they had intended to promote" for which reason, "the *only* consideration" for defendants' promise to pay was the engagement of the plaintiffs whereby they bound themselves to suspend criminal proceedings.

There was no such undertaking in the *Garrido* case.

The case of *Reyes vs. Gonzales* ([C.A.] 45 O.G. 831.) refers to a deed of mortgage with a false cause, the true consideration for which was the release of the accused in a criminal case or the dismissal of the same. Besides, it did not appear that said accused admitted either the offense charged or their liability, and in consequence of said contract "the investigation was stifled."

In the *Garrido* case, the accused (D), unlike the accused in the *Gonzales* case, had been investigated and his obligation to pay the complainant (C) was admitted. It appeared that the complaint was dropped

by the fiscal who investigated the case because the evidence was insufficient to secure D's conviction. In short, D and G did not agree "to actively assist in preventing the due investigation of the criminal charge."

**ART. 1353. The statement of a false cause in contracts shall render them void, if it should not be proved that they were founded upon another cause which is true and lawful. (1276)**

### Effect of falsity of cause.

By *falsity of cause* is meant that the contract states a valid consideration but such statement is not true.

A false cause may be erroneous or simulated. The first always produces the inexistence of a contract. If the cause is false, the contract is rendered void because the same actually does not exist. (Arts. 1353, 1409[3].) The second does not always produce this effect, because it may happen that the hidden but true cause is sufficient to support the contract. If the parties can show that there is another cause and that said cause is true and lawful, then the parties shall be bound by their true agreement. (Art. 1346.)

EXAMPLES:

(1) X promised to give to Y P1,000.00 as payment for past services allegedly rendered by Y which in truth and in fact have not been rendered; or for a carabao which unknown to X is already dead.

Here, the cause for X, the service remunerated or the promise of Y to sell the carabao, is *erroneous* as it is based upon facts believed to be existing, but really inexistent.

(2) S sells to B a parcel of land. In the deed of sale, P100,000.00 is stated as the price of the land. If this statement is false, then there is no contract of sale.

However, if B can prove that the contract is founded upon another consideration, as when B has exchanged his car for the land, then the contract of barter or exchange (not sale) shall be valid. In this case, the statement of the price is *simulated* because it is wilfully made. (see Arts. 1345, 1346.) Otherwise stated, there is, in fact, a real consideration but the same is not the one stated in the contract.

ILLUSTRATIVE CASES:

1. *Real consideration of a promissory note is partly legal and partly illegal.*

*Facts:* D executed a promissory note in favor of C for *money received* by D, when it was in fact for losses in *monte* and *burro,* the former a prohibited game, and the latter not a prohibited one. It was proven by D that the consideration was false.

*Issue:* Can C recover the amount of the promissory note without proving how much was lost at the game not prohibited?

*Held:* No. In this case, the consideration for the note is partly legal and partly illegal. By the terms of Article 1353, the burden of proof is upon C to show that there was a lawful consideration, and to show what part of the amount was won at the game of *burro.* C cannot recover unless he proves that part of the amount supported by the lawful consideration. *(Lichauco vs. Martinez, 6 Phil. 594 [1906].)*

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2. *Loan was contracted from a person to pay a non-existent obligation to another and the borrower refuses to pay loan.*

*Facts:* D was indebted to C. Upon the death of C, D entered into negotiations with H who claimed himself to be the heir of C. In the negotiations, D obtained P1,000.00 from E who paid the said amount to H. D also asked E to pay P3,000.00 to H, which amount E paid.

It turned out that H was not the heir of C. The obligation contracted by D to pay H was, therefore, founded on a false consideration, due to the erroneous belief of D in contracting the same that H was the legitimate heir of C.

*Issue:* Does this falsity of consideration operate to release D from the obligation to E?

*Held:* No. The right of E is founded on the loan made by him to D and not on the obligation contracted by D, without consideration or for a false consideration in favor of H. Whatever may be the legal nature of the juridical relation which existed between D and H, it had nothing to do with that established between D and E, by virtue of the said loan. This latter relation is entirely distinct and separate from the former. *(Lee Liong vs. Hizola, 19 Phil. 57 [1911].)*

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3. *Mortgage was executed to secure debts of a firm, and preserve it intact, the mortgagors erroneously believing that they are partners and not creditors thereof.*

*Facts:* Plaintiffs executed a mortgage to secure the debts of a firm under the impression that they were partners of said firm. It was later decided by the court, however, they were creditors of and not partners in the firm.

*Issue:* Was there a sufficient consideration or cause for the mortgage contract?

*Held:* Yes. The plaintiffs' desire to preserve the firm intact in the hope of recovering from it in due course their total credits constitutes a sufficient consideration. Whether they were creditors or partners did not matter, because in either case, they were interested in tiding the firm over its financial difficulties and in preserving it intact. Article 1353 applies. *(Ibañez de Aldecoa vs. Hongkong & Shanghai Bank, 31 Phil. 339 [1915].)*

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4. *There is an apparent gross disproportion between the stipulated price and the undisputably valuable real estate.*

*Facts:* In two (2) deeds of sale, real properties assuredly worth in actual value of at least P10,500.00 going only by assessments for tax purposes "which, it is well known, are notoriously low indicators of actual value" — were sold at a stated price of only P1.00 in each deed plus unspecified past, present and future services to which no value was assigned.

*Issue:* Are said deeds void or merely voidable?

*Held:* Upon the consideration alone that the apparent gross, not to say enormous, disproportion between the stipulated price and the undisputably valuable real estate, allegedly sold, plainly and unquestionably demonstrates that they state a false and fictitious consideration, and no other true and lawful cause having been shown, both deeds insofar as they purport to be sales, are not merely voidable, but void *ab initio. (Bagnes vs. Court of Appeals, 176 SCRA 159 [1989].)*

**ART. 1354. Although the cause is not stated in the contract, it is presumed that it exists and is lawful, unless the debtor proves the contrary. (1277)**

## Cause presumed to exist and lawful.

It is not necessary that the cause be expressly stated in the contract. The presumption is that the cause exists and is lawful unless the debtor proves the contrary. (Zayco vs. Serra, 44 Phil. 326 [1923]; Lim vs. Lim

Chu Kao, 51 Phil. 476 [1928]; Papa and Delgado vs. Montenegro, 54 Phil. 331 [1930].)

This presumption is in accord with the natural order of things. Ordinarily, a person will not part with his property unless there is a consideration. It is only *prima facie* and must yield to contrary evidence. (Castro vs. Escutin, 90 SCRA 349 [1979]; San Luis vs. Negrete, 98 SCRA 82 [1980]; see Ong vs. Ong, 139 SCRA 133 [1985].) The presumption that a contract has a sufficient consideration cannot be overthrown by a mere assertion that it has no consideration. (Fernandez vs. Fernandez, 153 SCAD 787, 363 SCRA 811 [2001].) To overcome the presumption, the alleged lack of consideration must be shown by preponderance of evidence. (Saguid vs. Security Finance, Inc., 477 SCRA 256 [2006]; Surtida vs. Rural Bank of Malinao, 511 SCRA 507 [2006].)

EXAMPLE:

D issued in favor of C a promissory note which recites:

"Thirty days after date, I promise to pay C or order the amount of P1,000.00." Signed "D."

Although the promissory note does not mention the consideration, the law presumes that D must have received a consideration for the debt and that the same is lawful, and furthermore, that it is sufficient or adequate. (see Art. 355.)

ILLUSTRATIVE CASE:

*Promissory note was given for money lost at a game not shown by debtor to be prohibited by law.*

*Facts:* C brought action upon a promissory note against D who alleged as a defense that the note was given for money lost at a game of power and that the game was a game of chance prohibited by law. No evidence was offered by D to show the nature of the game.

*Issue:* Without such evidence, can the court assume that poker was a game of chance?

*Held:* No. The note did not mention any consideration. By the terms of Article 1354, it is presumed that a consideration existed and that it was lawful, unless the debtor (D) proves the contrary. In the case of *Lichauco vs. Martinez (supra.),* a consideration was expressed, which consideration was proven by the debtor to be false. *(Sparrevohn vs. Bachrach, 7 Phil. 194 [1906].)*

**ART. 1355. Except in cases specified by law, lesion or inadequacy of cause shall not invalidate a contract, unless there has been fraud, mistake or undue influence. (n)**

### Meaning of lesion.

*Lesion* is any damage caused by the fact that the price is unjust or inadequate. (8 Manresa 740.)

It is the injury suffered in consequence of inequality of situation, by one party who does not receive the full equivalent for what he gives in a commutative contract, like a sale. (Bouvier's Law Dictionary, p. 1929.)

### Effect of lesion or inadequacy of cause.

(1) *General rule*. — Lesion or inadequacy of cause (*e.g.*, price of thing sold) does not of itself invalidate a contract. (Ereñeta vs. Bezore, 54 SCRA 13 [1973].) The general rule is that a party to a contract will not be relieved from his obligation under it by the mere fact that the contract may turn out to be financially disadvantageous to him. The reason for this rule is explained by the Supreme Court this wise:

> "All men are presumed to be sane and normal and subject to be moved by substantially the same motives. When of age and sane they must take care of themselves. In their relations with others in the business of life, wits, sense, intelligence, training, ability, and judgment meet and clash and contest sometimes with gain and advantage to all, sometimes to a few only with loss and injury to others. In these contests, men must depend upon themselves — upon their own abilities, talents, training, sense, acumen, judgment.
>
> The fact that one may be worsted by another, of itself furnishes no cause of complaint. One man cannot complain because another is more able or better trained, or has a better sense of judgment than he had. And when the two meet on a fair field, the inferior cannot murmur if the battle goes against him. The law furnishes no protection to the inferior simply because he is inferior, any more than it protects the strong because he is strong. It furnishes protection to both alike, to one no more than to the other. It makes no distinction between the wise and the foolish, the great and the small, the strong and the weak. The foolish may lose all they have

to the wise, but that does not mean that the law will give it back to them again.

Courts cannot follow every step of one's life and extricate him from bad bargains, protect him from unwise investments, relieve him from one-sided contracts, or annul the effects of foolish acts. Courts cannot constitute themselves guardians of everyone. Courts operate not because one person has been defeated or overcome by another, but because he had been defeated or overcome illegally. Man may do foolish things, make ridiculous contracts, use miserable judgments, and lose money on them — indeed all they have in the world but not for that alone can the law intervene and restore. There must be, in addition, a violation of law, the commission of what the law knows as an actionable wrong before the courts are authorized to lay hold of the situation and remedy it." (Vales vs. Villa, 35 Phil. 769 [1916]; see Cebu Portland Cement Co. vs. Dumon, 61 SCRA 218 [1974]; Philippine Aluminum Wheels, Inc. vs. FASGI Enterprises, Inc., 342 SCRA 722 [2000].)

*Note:* This ruling should be deemed modified by Article 1267, a new provision, which authorizes a court to *release* an obligor from an obligation, in whole or in part, when performance thereof *has become* so difficult as to be manifestly beyond the contemplation of the parties. Inadequacy of price is of no moment where the judgment debtor has a right to redeem.

(2) *Exceptions*. — Lesion will invalidate a contract —

(a) when there has been fraud, mistake, or undue influence (Art. 1355.); and

(b) in cases specified by law. (see Art. 1381.)

The rule in Article 1355 "is a general principle of modern law. The exceptions are self-evident." (Report of the Code Commission, p. 137.)

(3) *Related provisions.* — The following provisions of law are pertinent:

"Art. 1098. A partition, judicial or extrajudicial, may also be rescinded on account of lesion, when any one of the co-heirs received things whose value is less, by at least one-fourth, than the share to which he is entitled, considering the value of the things at the time they were adjudicated."

"Art. 1470. Gross inadequacy of price does not affect a contract of sale, except as it may indicate a defect in the consent, or that the parties really intended a donation or some other act or contract."

"Art. 1539. x x x ."

If the sale of real estate should be made with a statement of its area, at the rate of a certain price for a unit of measure or number, the vendor shall be obliged to deliver to the vendee, if the latter should demand it, all that may have been stated in the contract; but should this be not possible, the vendee may choose between a proportional reduction of the price and the rescission of the contract, provided, that in the latter case, the lack in the area be not less than one-tenth of that stated.

The same shall be done, even when the area is the same, if any part of the immovable is not of the quality specified in the contract.

The rescission, in this case, shall only take place at the will of the vendee, when the inferior value of the thing sold exceeds one-tenth of the price agreed upon.

Nevertheless, if the vendee would not have bought the immovable had he known of its smaller area or inferior quality, he may rescind the sale."

"Art. 1542. In the sale of real estate, made for a lump sum and not at the rate of a certain sum for a unit of measure or number, there shall be no increase or decrease of the price, although there be a greater or less or area or number than that stated in the contract.

The same rule shall be applied when two or more immovables are sold for a single price; but if, besides mentioning the boundaries, which is indispensable in every conveyance of real estate, its area or number should be designated in the contract, the vendor shall be bound to deliver all that is included within said boundaries, even when it exceeds the area or number specified in the contract; and, should he not be able to do so, he shall suffer a reduction in the price, in proportion to what is lacking in the area or number, unless the contract is rescinded because the vendee does not accede to the failure to deliver what has been stipulated."

"Art. 1602. The contract shall be presumed to be an equitable mortgage in any of the following cases: (1) When the price of a sale with right to repurchase is unusually inadequate. x x x."

ILLUSTRATIVE CASE:

*Purchase price was grossly inadequate and seller was an invalid.*

*Facts:* In a notarized instrument, S sold to B for P700.00 a parcel of land with an area of over 18 hectares and an assessed value of over P4,310.00. At the time of the execution of the deed of sale, S was already 100 years old and very weak. As a matter of fact, he could not talk when his thumbmark was affixed to the said deed.

*Issue:* Is the sale valid?

*Held:* No. It is void for lack of consent. "The consideration of P700.00 is not only grossly inadequate but is shocking to the conscience. No sane person would sell the land claimed by the defendants (heirs of B) for only P40.00 per hectare." (*Javier vs. Cruz, 80 SCRA 343 [1977];* see Rivero vs. Court of Appeals, 80 SCRA 411 [1977].)

(4) *Filial love or affection.* — In a case, the Supreme Court did "not find the stipulated price as so inadequate to shock the court's conscience considering that the price paid was much higher than the assessed value of the subject properties and considering that the sales were effected by a father to her daughter in which case filial love must be taken into account." (Alsua Betts vs. Court of Appeals, 92 SCRA 332 [1970].)

Affection may be included as a portion of the consideration. (Dy vs. Sacay, 165 SCRA 473 [1988].) A valuable consideration, however small and nominal if given or stipulated in good faith is, in the absence of fraud, sufficient. (Rodriguez vs. Court of Appeals, 207 SCRA 553 [1992]; Penaco vs. Ruaya, 110 SCRA 46 [1981]; Ascalon vs. Court of Appeals, 158 SCRA 542 [1988].)

### Simulation of contract and gross inadequacy of price distinct concepts.

Simulation of contract (Arts. 1345, 1346) and gross inadequacy of price are distinct legal concepts, with different effects. When the parties to an alleged contract do not really intend to be bound by it, the contract is simulated and void. A simulated or fictitious contract has no legal effect whatsoever (see Arts. 1352, 1409[2].) because there is no real agreement between the parties.

In contrast, a contract with inadequate consideration may nevertheless embody a true agreement between the parties. A contract of

sale is a consensual contract, which becomes valid and binding upon the meeting of minds of the parties on the price and the object of the sale. The concept of a simulated sale is thus incompatible with inadequacy of price. When the parties agree on a price as the actual consideration, the sale is not simulated despite the inadequacy of the price. (Bravo-Guerrero vs. Bravo, 465 SCRA 244 [2005].)

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# Chapter 3

# FORM OF CONTRACTS

**ART. 1356. Contracts shall be obligatory, in whatever form they may have been entered into, provided all the essential requisites for their validity are present. However, when the law requires that a contract be in some form in order that it may be valid or enforceable, or that a contract be proved in a certain way, that requirement is absolute and indispensable. In such cases, the right of the parties stated in the following article cannot be exercised. (1278a)**

### Meaning of form of contracts.

The *form of a contract* refers to the manner in which a contract is executed or manifested.

### Forms of contract.

(1) The contract may be (a) parol or oral, or (b) in writing, or (c) partly oral and partly in writing. If in writing, it may be in a public or a private instrument.

(2) A contract need not be contained in a single writing. It may be collected from different writings which do not conflict with each other and which when connected, show the parties, subject matter, terms and consideration, as in contracts entered into by correspondence. (17 C.J.S. 727-728.)

(3) A contract may be encompassed in several instruments even though every instrument is not signed by the parties since it is sufficient if the unsigned instruments are clearly identified or referred to and made part of the signed instrument or instruments. (*Ibid.*, p. 728.)

(4) Similarly, a written agreement of which there are two copies, one signed by each of the parties is binding on both to the same extent

as though there had been only one copy of the agreement and both had signed. (*Ibid.,* p. 729, cited in BF Corporation vs. Court of Appeals, 93 SCAD 72, 288 SCRA 267 [1998].)

### When contract considered in written form.

It is generally recognized that to be a written contract, all its terms must be in writing. So, a contract partly in writing and partly oral is, in legal effect, an oral contract. (12 Am. Jur. 550; Manuel vs. Rodriguez, 109 Phil. 1 [1960].)

(1) In a case, "only the price and the terms of payment were in writing," but the most important matter in the controversy, the alleged transfer of title was never "reduced to any written document." It was held that the contract should not be considered as a written but an oral one, not a sale but a promise to sell; and that "the absence of a formal deed of conveyance" was a strong indication "that the parties did not intend immediate transfer of title but only a transfer after full payment of the price." (Alfonso vs. Court of Appeals, 186 SCRA 400 [1990].)

(2) In another case, the agreement of the parties was embodied in a one-page handwritten document, without the usual terms and conditions of a formal deed of sale. The names and addresses of the parties and the indentity of the property could not be ascertained from the document. The spouses A and B, buyers, did not immediately take actual possession of the land sold in 1980 but in 1982, alleging that having made partial payments of the purchase price "they already considered themselves owners" of the land, the contract being a sale on installment basis. It was ruled that there was no transfer of title to A and B, and that the spouses C and D, sellers, retained their ownership of the land for the parties did not intend the transfer of ownership until full payment of the purchase price. (Ramos vs. Heruela, 473 SCRA 79 [2006].)

### Two aspects of contracts.

There is no contract, says Article 1318, unless the requisites of consent, object, and cause concur. But the concurrence of these elements in the minds of the parties without expression, will not produce a contract. Like every juristic act (*i.e.,* act which produces juridical effect, as lease, sale, marriage, etc.), a contract consists of two aspects, *viz.:*

(1) *Intent or will.* — This is internal and as long as a contract exists merely as a psychological fact, it produces no legal effect, because the law cannot take cognizance of its existence; and

(2) *Expression of such intent or will.* — It is necessary, in order that the will may produce legal effect, that it be expressed. This expression or declaration of the will is its form. On this basis, contracts are divided into formal and informal. (see G. Florendo, The Law of Obligations and Contracts [1936], p. 725.)

**Classification of contracts according to form.**

They are:

(1) *Informal* or *common contract* or that which may be entered into in whatever form, provided, all the essential requisites for their validity are present. (Art. 1356.) This refers only to consensual contracts (Art. 1356.), such as the contract of sale. An informal contract may be oral or written; and

(2) *Formal* or *solemn contract* or that which is required by law for its efficacy to be in a certain specified form.

**Rules regarding form of contracts.**

(1) *General rule.* — Contracts are binding and, therefore, enforceable reciprocally by the contracting parties, whatever may be the form in which the contract has been entered into provided all the three essential requisites (consent, object, and cause), for their validity are present.[1] (Hijos de I. de la Rama vs. Inventor, 12 Phil. 44 [1908].) In the matter of formalities, the contractual system of the Civil Code still follows that of the Spanish Civil Code of 1889 of upholding the spirit and

[1]With the emergence of the Internet economy, it is now possible for parties to do business with one another though one may be a stranger to the other, by electronic means, like through E-mail message or a Web site, otherwise known as electronic commerce or E-commerce. This has created a need for a legal framework governing cyberspace business transactions which are not in writing but transmitted electronically — in its very essence going against the traditional documentary nature of business contracts; and since E-commerce is borderless and spontaneous, it goes against the legal principle that all law is — *prima facie* territorial in application. R.A. No. 8792, otherwise known as the "Electronic Commerce Act" *(infra.),* aims to simplify and facilitate domestic and international exchange of information, transactions, agreements and contracts through the utilization of electronic technology and to recognize electronic documents or data messages related to such activities as having the same effect as that of paper documents required by law.

intent of the parties over formalities. This is plain from Articles 1315 and 1356. (Dauden-Hernaez vs. De los Angeles, 27 SCRA 1276 [1969].)

If the contract is not initially reduced to writing, this may be done later. (Deloso vs. Sandiganbayan, 217 SCRA 49 [1993].)

The fact that the previous contracts between the parties were all oral, does not necessarily mean that the subsequent contracts of similar or allied nature should also be oral and the procedure be the same. (Tong Brothers Co. vs. Intermediate Appellate Court, 156 SCRA 726 [1987].)

(2) *Exceptions*. — The form, however, is required in the following cases:

(a) when the law requires that a contract be in some form to be valid;

(b) when the law requires that a contract be in some form to be enforceable or proved in a certain way; or

(c) when the law requires that a contract be in some form for the convenience of the parties or for the purpose of affecting third persons. (Art. 1356.)

It has been held that a contract of agency to sell on commission basis does not belong to any of the three above categories; hence, it is valid and enforceable in whatever form it may be entered into. (Lim vs. Court of Appeals, 254 SCRA 170 [1996].) No particular form of evidence is required to prove the existence of an employer-employee relationship. Hence, the absence of a copy of the contract of employment will not in any manner negate the existence of the contract. (PMI Colleges vs. National Labor Relations Commission, 277 SCRA 462 [1997].) There is no provision of law requiring a note or memorandum for a contract of partition to be valid or enforceable. (Tan vs. Lim, 296 SCRA 455 [1998].)

**Form for validity of contract.**

There are rare cases when the law requires that a contract be in a certain form for the validity of the contract such as those mentioned below.

(1) *Donation of real property*. — It must be in a public instrument. (Art. 749.)

(2) *Donation of personal property the value of which exceeds P5,000.00*. — The donation and acceptance must be in writing. (Art. 748.)

(3) *Sale of land through an agent.* — The authority of the agent must be in writing; otherwise, the sale is void. (Art. 1874.)

(4) *Contract of antichresis.* — The amount of the principal and of the interest must be specified in writing. (Art. 2134.)

(5) *Stipulation to pay interest.* — It must be in writing; otherwise, no interest is due. (Art. 1956.)

(6) *Contract of partnership*. — If immovables are contributed, it must be in a public instrument to which shall be attached a signed inventory of the immovable property contributed. (Arts. 1771, 1773.)

(7) *Transfer or sale of large cattle.* — It must be registered (so it must be in a public instrument) and a certificate of transfer secured. (Act No. 1147, Sec. 22.)

(8) *Negotiable instruments.* — They must be in writing. (Act No. 2031, Sec. 1.)

### Form for enforceability of contract.

In the cases of contracts covered by the Statute of Frauds, the law requires that they be in writing subscribed by the party charged or by his agent. (Art. 1403[2].) If the contract is not in writing, the contract is valid (assuming all the essential elements are present) but, upon the objection of a party, it cannot be proved and, therefore, it cannot be enforced unless it is ratified. (Art. 1405.)

Unenforceable contracts are discussed under Chapter 8.

### Reasons for exceptions.

According to the Code Commission, Article 1356 combines the "spiritual system" of the old Civil Code and the principles of the Anglo-American law as manifested in the Statute of Frauds. The foundation is still the "spiritual system" so that in general, the contracting parties may, under Article 1357, compel each other to comply with the form required by law.

The requirement that certain contracts be in certain forms to be valid or enforceable is calculated to avoid litigation. Oral contracts frequently lead to fraud in the fulfillment of obligations or to false testimony. So long as the possibility of dishonesty exists in contractual relations, the "spiritual system" cannot be adopted in an unqualified manner. (Report of Code Commission, p. 138.) If the form required for

*validity* or *enforceability* of a contract is not observed, the parties cannot avail of the right granted under Article 1357.

> **ART. 1357. If the law requires a document or other special form, as in the acts and contracts enumerated in the following article, the contracting parties may compel each other to observe that form, once the contract has been perfected. This right may be exercised simultaneously with the action upon the contract. (1279a)**

### Form for the convenience of the parties.

In certain cases, a certain form (*e.g.,* public instrument) is required for the convenience of the parties in order that the contract may be registered in the proper registry to make effective, as against third persons, the right acquired under such contract. Non-compliance with the required form would not adversely affect the validity nor enforceability of the contract between the parties themselves.

As between the parties, the form is not indispensable since they are allowed by law to compel the other to observe the proper form and this right may be exercised simultaneously with the action to enforce the contract. *It is essential, however, before a party may be compelled to execute the required form, that the contract be both valid and enforceable.* (see Dauden-Hernaez vs. De los Angeles, 27 SCRA 1276 [1969].)

EXAMPLES:

(1) S donated real property to B in a private instrument. The donation is void because a donation of real property is required to be in a public instrument to be valid. Hence, Article 1357 does not apply.

(2) Suppose the contract is a sale of real property but it is entered into orally. The contract is valid but it is unenforceable because the law requires that it be in writing to be enforceable. (Art. 1403[2, e].) Hence, Article 1357 will not also apply. If the price has been paid or the property has been delivered, the contract is valid and enforceable because the Statute of Frauds *(Ibid.)* applies only to executory contracts.

An exchange of land is valid although not in writing. (Lopez vs. The Auditor General, 20 SCRA 655 [1967].)

(3) If the contract of sale is in private writing, then it is valid and binding, although it is still executory, but only as between the parties and not as against third persons without notice until the sale is registered in the Registry of Property.

If B is the vendee, he has a right to compel S to put the contract in a public instrument so that it can be registered to affect third persons (see Carbonell vs. Court of Appeals, 69 SCRA 99 [1976].) notwithstanding the absence of express agreement between them to that effect. For a sale of real property or of an interest therein to be enforceable under the Statute of Frauds, it is enough that it be in writing. It need not be notarized. (Heirs of Amparo del Rosario vs. Santos, 108 SCRA 43 [1981].)

Inasmuch as the contract is both valid and enforceable, the execution of a public instrument becomes a mere matter of form and convenience.

**ART. 1358. The following must appear in a public document:**

**(1) Acts and contracts which have for their object the creation, transmission, modification or extinguishment of real rights over immovable property; sales of real property or of an interest therein are governed by Articles 1403, No. 2, and 1405;**

**(2) The cession, repudiation or renunciation of hereditary rights or of those of the conjugal partnership of gains;**

**(3) The power to administer property, or any other power which has for its object an act appearing or which should appear in a public document, or should prejudice a third person;**

**(4) The cession of actions or rights proceeding from an act appearing in a public document.**

**All other contracts where the amount involved exceeds five hundred pesos must appear in writing, even a private one. But sales of goods, chattels or things in action are governed by Articles 1403, No. 2 and 1405. (1280a)**

## Contracts which must appear in a public document.

The contracts covered by this article are valid and enforceable though not embodied in a public document or instrument or in writing. The public document is required only for the convenience and greater protection of the parties and registration is needed only to make the contract effective as against third persons.

In other words, the law does not require accomplishment of certain acts or contracts in a public instrument in order to validate the act or contract but only to insure its efficacy so that after the existence of the act or contract has been admitted or established, the party bound

may be compelled to execute the document. (Hawaiian Phil. Co. vs. Hernaez, 45 Phil. 746 [1926]; see Cenido vs. Apacionado, 318 SCRA 688 [1999].)

Formal requirements are, therefore, for the benefit of third parties for the purpose of informing as well as binding them. Non-compliance therewith does not adversely affect the validity of the contract nor the contractual rights and obligations of the parties thereunder. (Fule vs. Court of Appeals, 286 SCRA 698 [1998]; Agasen vs. Court of Appeals, 325 SCRA 504 [2000]; Londres vs. Court of Appeals, 394 SCRA 133 [2002].)

Incidentally, a *public document* or *instrument* is one which is acknowledged before a notary public or any official authorized to administer oath, by the person who executed the same.[2] The party making the acknowledgment formally declares that the instrument is his free act and deed while the officer taking the same attests and certifies that such party is known to him and that he is the same person who executed the instrument and acknowledged that the instrument is his free act and deed.[3] Any other instrument is private.

A private document, however, acquires the character of a public document when it becomes part of an official record and is certified by a public officer duly authorized by law. (Monteverde vs. People, 387 SCRA 196 [2002].)

**Probative value of public documents.**

(1) The effect of the notarization of a private document is to convert the said document into a public one and render it admissible in evidence in court without further proof of its authenticity and due execution.[4] (Nadayag vs. Grageda, 237 SCRA 202 [1994]; see Agasen vs.

[2]Sec. 3. *Proof of electronically notarized document.* — A document electronically notarized in accordance with the rules promulgated by the Supreme Court shall be considered as a public document and proved as a notarial document under the Rules of Court. (Rule 5, Rules of Electronic Evidence.)

[3]An *acknowledgment* is the act of one who has executed a deed in going before some competent officer or court and declaring it to be his act or deed, while a *jurat* is that part of an affidavit where the officer certifies that the same was subscribed and sworn to before him. (Tigno vs. Aquino, 444 SCRA 61 [2004]; In-N-Burger, Inc. vs. Sehwani, Incorporated, 575 SCRA 535 [2008].)

[4]Section 22 of the Spanish Notarial Law of 1889 providing that a notary public could not authenticate a contract which contained provisions in his favor or to which any of the parties

Court of Appeals, 325 SCRA 504 [2000]; Loyola vs. Court of Appeals, 326 SCRA 235 [2000].)

(2) Public documents are entitled to full faith and credit on their face in the absence of any clear and convincing evidence, more than merely preponderant, that their execution was tainted by defects or irregularities that would warrant a declaration of nullity. (Anchuelo vs. Intermediate Appellate Court, 147 SCRA 434 [1987]; Antonio vs. Estrella, 156 SCRA 68 [1987]; P.T. Cerna Corp. vs. Court of Appeals, 221 SCRA 19 [1993].) One who denies the due execution of a deed where one's signature appears, has the burden of proving that, contrary to the recital in the *jurat*, one never appeared before the notary public and acknowledged the deed to be a voluntary act. (Dela Cruz vs. Sison, 451 SCRA 754 [2005].)

(3) They enjoy the presumption of validity and regularity. It is not, however, the intention nor the function of the notary public to validate and make binding an instrument never, in the first place, intended to have any binding legal effect upon the parties thereto. (Santiago vs. Court of Appeals, 277 SCRA 98 [1997].) The presumption is not absolute and, as stated above, may be rebutted by clear and convincing, not merely preponderant, evidence to the contrary. (Mendezona vs. Ozamiz, 376 SCRA 482 [2002].) Furthermore, notarization *per se* is not a guarantee of the validity of the contents of a document. (Mayor vs. Belen, 430 SCRA 561 [2004])

EXAMPLES:

(1) *Creation, etc. of real rights over immovable property.* — As security for his debt, R mortgaged his land to E. This mortgage must appear in a public document. The extinguishment of the mortgage, upon payment of the debt by R, must likewise appear in a public document. Sales of real property or an interest therein are governed by the Statute of Frauds. (Art. 1403[2].)

(2) *Cession or renunciation of hereditary rights or of those of conjugal partnership of gains.* — S and D are the heirs of F, their deceased father. S, being financially stable, renounces his share in the inheritance. This renunciation must appear in a public instrument.

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interested is a relative of his within the fourth civil degree or second degree of affinity no longer holds true with the enactment of Act No. 496 which repealed the Spanish Notarial Law. (Aznar Brothers Realty Co. vs. Court of Appeals, 327 SCRA 359 [2000].)

(3) *Power to administer property.* — P is leaving for the United States to study for two (2) years. He appoints A to manage his property. In this case, the authority of A to administer the property of P must appear in a public document.

(4) *Cession of actions or rights.* — R mortgaged his land to E to secure the payment of a debt. This mortgage appears in a public document. The cession by E of his right, as mortgagee, to T, must also be in a public document.

ILLUSTRATIVE CASE:

*The only evidence of contract of sale is a receipt acknowledging the amount of P200.00.*

*Facts:* The probate court authorized S, as special co-administrator, to sell a subdivision. Under the authority, S sold a lot on installment basis to B who paid an initial amount of P200.00 by virtue of which, S issued a receipt. Subsequently, the court issued another order authorizing X (bank), as administrator, to sell the subdivision at the earliest possible time at the best obtainable price. X sold the entire subdivision to MR. It refused to receive further payments from B.

The lower court ruled that there was consummated sale between S and B because they had agreed on the subject matter and the purchase price and that the latter paid part of the purchase price while the former delivered the land.

*Issue:* Did the sale between S and B bind MR who acquired the property with the approval of the probate court and in sole reliance on the clean title of the property?

*Held:* No. The alleged sale made by S to B should have been embodied in a public instrument in accordance with Article 1358 and duly registered with the Register of Deeds to make it binding against third persons. The authority given by the probate court to S specifically required the execution of accessory documents.

B not only failed to obtain a deed of sale from S but also failed to secure any kind of writing evidencing the contract of sale other than the receipt issued by S. No explanation was offered as to why there was no effort on the part of B for about five (5) years to pay the balance of the purchase price during the time that S was the special co-administrator. *(Manotok Realty, Inc. vs. Court of Appeals, 149 SCRA 174 [1987].)*

**Action to compel execution of contract in public instrument.**

Under Article 1357, the parties may compel each other to have the contract reduced in proper form and the action may be filed simultaneously with the suit to enforce the contract. But the latter action may be brought without the bringing of the former.

The reduction to writing in a public or private document, required by the law with respect to certain contracts, is not an essential requisite of their existence, but is simply a coercive power granted to the contracting parties by which they can reciprocally compel the observance of these formal requisites. (Thunga Chui vs. Que Bentec, 2 Phil. 651 [1903].) The contract can be enforced even if it may not be in writing. (Shaffer vs. Palma, 22 SCRA 934 [1968].) But before the contract can be reduced in proper form or enforced, it may be necessary to prove its existence.

ILLUSTRATIVE CASE:

*Plaintiff brought action to enforce a partnership contract entered into orally without first asking that it be reduced to writing.*

*Facts:* X and Y contributed P1,000.00 and P2,000.00, respectively, to a partnership which was entered into, orally, between them. X brought action on the partnership contract. Y now claims that the case falls under Article 1358 (last par.) and that before X can maintain any action on the verbal contract, he must proceed under Article 1357 to compel Y to reduce it to writing.

*Issue:* Is this contention of Y well-founded?

*Held:* No. Article 1357 does not impose an obligation, but confers a privilege upon both contracting parties and the fact that X has not made use of the same, does not bar his action. Far from making the enforceability of the contract dependent upon any special extrinsic form, Article 1357 recognizes its enforceability by the mere act of granting to the contracting parties, an adequate remedy to compel the execution of a public writing, or any other special form, notwithstanding the absence of any express agreement by them to that effect, whenever such form is necessary in order that the contract may produce the effect which is desired, according to whatever may be its object.

The subordination of the principal action for the enforcement of the contract to the bringing of the secondary action concerning the form would be unnecessary as the cause of action would be the same in both

cases, *i.e.*, the existence of a valid contract. *(Thunga Chui vs. Que Bentec, supra.)*

**Legal recognition of electronic data messages and electronic documents.**

R.A. No. 8792, otherwise known as the "Electronic Commerce Act[5] (June 14, 2000) gives legal recognition to any kind of electronic data message and electronic document used in the context of commercial and non-commercial activities to include domestic and international dealings, transactions, arrangements, agreements, contracts and exchanges and storage of information. (Sec. 4, *Ibid*.)

(1) *Electronic data message.* — Information shall not be denied validity or enforceability solely on the ground that it is in the form of an electronic data message purporting to give rise to such legal effect, or that it is merely incorporated by reference in that electronic data message. (Sec. 6, *Ibid.*)

(2) *Electronic documents.* — Electronic documents shall have the legal effect, validity or enforceability as any other document or legal writing, and —

(a) Where the law requires a document to be in writing, that requirement is met by an electronic document if the said electronic document maintains its integrity and reliability and can be authenticated so as to be usable for subsequent reference, in that —

1) The electronic document has remained complete and unaltered, apart from the addition of any endorsement and any authorized change, or any change which arises in the normal course of communication, storage and display; and

2) The electronic document is reliable in the light of the purpose for which it was generated and in the light of all relevant circumstances.

(b) Paragraph (a) applies whether the requirement therein is in the form of an obligation or whether the law simply provides consequences for the document not being presented or retained in its original form.

[5]For definition of terms and other provisions, see Comments under Arts. 1323 and 1403.

(c) Where the law requires that a document be presented or retained in its original form, that requirement is met by an electronic document if —

1) There exists a reliable assurance as to the integrity of the document from the time when it was first generated in its final form, and

2) That document is capable of being displayed to the person to whom it is to be presented. For evidentiary purposes, an electronic document shall be the functional equivalent of a written document under existing laws.

The Act dose not modify any statutory rule relating to the admissibility of electronic data messages or electronic documents except the rules relating to authentication and best evidence; nor shall it apply to vary any and all requirements of existing laws on formalities required in the execution of documents for their validity. (Sec. 7, *Ibid.*)

(3) *Variation by agreement.* — As between parties involved in generating, sending, receiving, storing or otherwise processing electronic data message or electronic document, any provision of the Act may be varied by agreement between and among them. (Sec. 38, *Ibid.*)

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# Chapter 4

# REFORMATION OF INSTRUMENTS (n)

**ART. 1359. When, there having been a meeting of the minds of the parties to a contract, their true intention is not expressed in the instrument purporting to embody the agreement, by reason of mistake, fraud, inequitable conduct or accident, one of the parties may ask for the reformation of the instrument to the end that such true intention may be expressed.**

**If mistake, fraud, inequitable conduct, or accident has prevented a meeting of the minds of the parties, the proper remedy is not reformation of the instrument but annulment of the contract.**

## Meaning of reformation.

*Reformation* is that remedy by means of which a written instrument is amended or rectified so as to express or conform to the real agreement or intention of the parties when by reason of mistake, fraud, inequitable conduct, or accident, the instrument fails to express such agreement or intention.

It is to be distinguished from interpretation. (Chap. 5.)

## Reason for reformation.

"Equity orders the reformation of an instrument in order that the intention of the contracting parties may be expressed.

The courts do not attempt to make another contract for the parties. The rationale of the doctrine is that it would be unjust and inequitable to allow the enforcement of a written instrument which does not reflect or disclose the real meeting of the minds of the parties. The rigor of the legalistic rule that the written instrument should be the final and

inflexible criterion and measure of the rights and obligations of the contracting parties is thus tempered, to forestall the effects of mistake, fraud, inequitable conduct, or accident." (Report of the Code Commission, pp. 55-56; see Cosio vs. Palileo, 14 SCRA 170 [1965].)

**Requisites of reformation.**

In order that reformation may be availed of as a remedy, the following requisites must be present:

(1) There is a meeting of the minds of the parties to the contract;

(2) The written instrument does not express the true agreement or intention of the parties;

(3) The failure to express the true intention is due to mistake, fraud, inequitable conduct, or accident;

(4) The facts upon which relief by way of reformation of the instrument is sought are put in issue by the pleadings; and

(5) There is clear and convincing evidence[1] (which is more than mere preponderance of evidence) of the mistake, fraud, inequitable conduct, or accident.

Both parties must have executed a writing that does not reflect their actual agreement. Reformation is thus not available where no writing exists, or a writing exists, but the parties do not intend it to express their final agreement, or no attempt is made to show any vice of consent therein.

**Ultimate facts to be alleged and proved in action for reformation.**

(1) In an action for the reformation[2] of an instrument, the complaint must allege the true agreement or intention of the parties and that the instrument to be reformed does not express such agreement or intention. In the absence of such allegation, there is no cause of action stated. It is not the function of the remedy to make a new agreement, but to establish and perpetuate the true existing contract between the

[1]This standard of proof is necessary because the remedy requires the court to disregard the parol evidence rule.

[2]An action for reformation is *in personam,* not *in rem,* even when real estate is involved. It is merely an equitable relief. The remedy may not be applied when against statutory law. (Huibonhoa vs. Court of Appeals, *supra.*)

parties which, under the technical rules of law, could not be enforced but for such reformation. (see Garcia vs. Bisaya, 97 Phil. 609 [1955]; Quiros vs. Arjona, 425 SCRA 57 [2004].)

In reformation of contracts, what is reformed is not the contract itself, but the instrument embodying the contract. It follows that whether the contract has become disadvantageous or not under Article 1267 is irrelevant to reformation and, therefore, cannot be an element in the determination of the period for prescription of the action to reform under Article 1144(1) of the Civil Code. (Naga Telephone Co., Inc. vs. Court of Appeals, 230 SCRA 351 [1994].)

(2) The *onus probandi* is upon the party who insists that the contract should be reformed because of its failure to express the true intention of the parties because the presumption is that an instrument sets out the true agreement of the parties. A contract may not be reformed simply because a party later finds itself at the shorter end of an unwise bargain. It is only when the agreement is shown to be so grossly unjust as to be unduly oppressive that the strong arm of equity may intervene to grant relief to the aggrieved party. (see Mata vs. Court of Appeals, 207 SCRA 753 [1992]; see Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999].)

**Admissibility of parol evidence to show true intent.**

As a general rule, the court may not allow the introduction of parol evidence to show the real agreement of the parties. Whatever is not found in the text of the agreement should thus be construed as excluded, waived, or abandoned.

The Rules of Court provides:

> "*Evidence of written agreements.* — When the terms of an agreement have been reduced to writing, it is considered as containing all the terms agreed upon and there can be, between the parties and their successors in interest, no evidence of such terms other than the contents of the written agreement.[3]

[3]Under the Rules on Electronic Evidence, an electronic document authenticated in the manner by said Rules is admissible in evidence as the functional equivalent of a paper-based document, record, instrument, memorandum or any other form of writing. (Sec. 1, Rule 3, thereof.) For definition of terms and other provisions, see Comments under Articles 1323, 1358, and 1403.

However, a party may present evidence to modify, explain or add to the terms of the written agreement if he puts in issue in his pleading:

(a) An intrinsic ambiguity, mistake or imperfection in the written agreement;

(b) The failure of the written agreement to express the true intent and agreement of the parties thereto;

(c) The validity of the written agreement; or

(d) The existence of other terms agreed to by the parties or their successors in interest after the execution of the written agreement.

The term 'agreement' includes wills.'' (7a) (Sec. 9, Rule 130.)

The mistake contemplated as an exception to the parol evidence rule is one which is a mistake mutual to the parties. (Gurango vs. Intermediate Appellate Court, 215 SCRA 332 [1992].)

The parol evidence rule forbids any addition to or contradiction of the terms of a written instrument by testimony purporting to show that, at or before the signing thereof, other or different terms were orally agreed upon by the parties. Simply put, any oral evidence of an agreement should be excluded when after all, the existing agreement is already in writing. The ground that the written agreement fails to express the true intent and agreement of the parties can only be invoked, as an exception, where the contract is so ambiguous or obscure in terms that the contractual intention of the parties cannot be understood from a mere reading of the instrument. (Heirs of Amparo del Rosario vs. Santos, 108 SCRA 43 [1981]; Uy Roque vs. Sioca, 43 Phil. 405 [1922]; Congregation of the Religious of Virgin Mary vs. Court of Appeals, 291 SCRA 385 [1998].)

The right of reformation is necessarily an invasion or limitation of the parol evidence rule since, when a writing is reformed, the result is that an oral agreement is, by court decree, made legally effective. Consequently, courts as the agencies authorized by law to exercise the power to reform an agreement, must necessarily exercise that power sparingly and with great caution. (Rosello-Benter vs. Leanda, 330 SCRA 591 [2000].)

But even when the terms of a contract purporting to be a *pacto de retro* sale or an absolute sale are not ambiguous, it should be construed

as a mortgage or a loan when the circumstances surrounding its execution or its performance are incompatible or inconsistent with the theory that it is a sale pursuant to Articles 1602 and 1604 (see Note 5 under Art. 1365.) of the Civil Code. (see Olea vs. Court of Appeals, 247 SCRA 274 [1995].) Documentary and parol evidence may be admitted to prove the intention of the parties. (Reyes vs. Court of Appeals, 339 SCRA 97 [2000].)

ILLUSTRATIVE CASES:

1. *Verbal agreement binding vendee to allow repurchase by vendor was intended by the parties as part of the consideration of the written contract of absolute sale.*

*Facts:* An absolute deed of sale of several parcels of land was executed by S (vendor) and B (vendee). In an action by S to compel B to allow the repurchase of the property, S alleged that his verbal agreement with B binding the latter to execute another document giving him the right to redeem the property was the real inducement on his part in making the contract of absolute sale and that B subsequently refused to put this right in writing.

*Issue:* Should S be allowed to present parol evidence of the verbal agreement?

*Held:* Yes. This is a case of a clearly established promise on the part of B to give a counter-contract expressing S's right to redeem. If in case of mutual mistake, the introduction of evidence to show the intention of the parties is allowed, there is no reason why in a case of a more serious nature, like the case presented, evidence to show the existence of a verbal agreement which constitutes a part of the consideration of the written contract should not be allowed.

It is true that the parol evidence has the effect of modifying the agreement but this should not prohibit the court to force B to live up to his contract in its entirety and to prevent him to commit fraud. *(Yacapin and Neri Linan vs. Neri, 40 Phil. 61 [1919].)*

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2. *Written contract shows an independent contractorship but employer-employee relationship is sought to be established.*

*Facts:* X and Y who claimed to be employees of C (corporation), sued C before the NLRC (National Labor Relations Commission) for illegal dismissal. The contract between the parties, designated as peddling contract, shows upon its text, an independent contractorship.

*Issue:* May X and Y adduce evidence before the NLRC of external facts which might establish an employer-employee relationship?

*Held:* No. The NLRC has no jurisdiction over the case. However, X and Y may sue in the proper Court of First Instance (now Regional Trial Court) and ask for a reformation of the instrument evidencing the contract, or for its annulment or to secure a declaration that, disregarding the peddling contract, the actual juridical relationship between the parties is that of employer and employee. *(Mafinco Trading Corp. vs. Ople, 70 SCRA 139 [1976].)*

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3. *That a document does not express the true intention of the parties was not put in issue by the pleadings.*

*Facts:* R, etc. filed a complaint to annul a supposed conditional donation of two (2) parcels of land made by them to PNR for alleged non-fulfillment of the conditions of the donation. PNR objected to a question of plaintiffs' counsel asking R to tell the court the promise of PNR with respect to the execution of the deed on the ground that the deed had no condition whatsoever.

The plaintiffs did not expressly plead that the deed of donation was incomplete or that its execution was vitiated by mistake or that it did not reflect the intention of the donor and the donee. The lower court ruled that the question should be allowed.

*Issue:* Would the answer to the question be a transgression of the parol evidence rule?

*Held:* Yes. The lower court committed a grave abuse of discretion in not sustaining PNR's objection based on the parol evidence rule. In order that parol or extrinsic evidence may be admitted to vary the terms of a writing, the mistake, etc. should be put in issue by the pleadings. R, etc., in their complaint merely alleged that the donation was subject to five (5) conditions. Then, they prayed that the donation be annulled or rescinded for non-compliance with the supposed resolutory conditions. They could have asked for the reformation of the deed of donation.

But whether the action is for revocation or reformation, it was necessary for them, in order to prove that the donation was conditional, to plead that the deed of donation did not express the true intent of the parties. *(Phil. National Railways vs. CFI of Albay, 83 SCRA 569 [1978].)*

### What constitutes inequitable conduct.

*Inequitable conduct,* to warrant relief by way of reformation, has been held to consist in doing acts, or omitting to do acts, which the court finds to be unconscionable. Examples are:

(1) Taking advantage by one party of the other party's illiteracy;

(2) abusing confidence;

(3) concealing what of right should have been disclosed;

(4) drafting or having drafted an instrument contrary to the previous understanding of the parties and making the other party to believe the instrument other than it actually is; or

(5) in taking advantage of a mistake of the other party, known or suspected at the time of the execution of the instrument. (see 53 C.J. 950-952.)

**Reformation and annulment distinguished.**

In reformation, there has been a meeting of the minds of the parties (Art. 1359, par. 1.); hence, a contract exists but the written instrument purporting to embody the contract does not express the true intention of the parties by reason of mistake, fraud, inequitable conduct, or accident. Under the technical rules of law, the real contract cannot be enforced until it is reformed.

In annulment, there has been no meeting of the minds, the consent of one of the parties being vitiated by mistake, etc. (*Ibid.,* par. 2; see Art. 1390.)

Reformation and annulment are thus inconsistent with each other. While the first gives life to a contract upon certain conditions, the second involves a complete nullification of it. (Castillo vs. Court of Appeals, 159 SCRA 220 [1988].)

EXAMPLE:

S sold his land to B. It was agreed that the sale will include all the improvements. However, the contract as signed by the parties, states that the land is being sold, excluding the improvements thereon.

In this case, the remedy is reformation because there has been a meeting of the minds. But if S was selling his land "excluding" the improvements and B was buying the land "including" the improvements, then there has been no meeting of the minds and the remedy, therefore, is annulment. Reformation cannot be the remedy because, either way, it would not make the instrument express the real intention of both parties.

**ART. 1360. The principles of the general law on the reformation of instruments are hereby adopted insofar as they are not in conflict with the provisions of this Code.**

### Principles of the general law on reformation.

In case of conflict between the provisions of the new Civil Code and the principles of the general law on reformation, the former prevail. The latter will have only suppletory effect.

**ART. 1361. When a mutual mistake of the parties causes the failure of the instrument to disclose their real agreement, said instrument may be reformed.**

### Mutual mistake as basis for reformation.

To justify reformation under this article, the following requisites must concur:

(1) The mistake must be of fact (see Art. 1331.), for if it is one of law, the remedy is annulment (see Art. 1334.);

(2) Such mistake must be proved by clear and convincing evidence;

(3) The mistake must be mutual, that is, common to both parties to the instrument; and

(4) The mistake must cause the failure of the instrument to express their true intention. (Bank of P.I. vs. Fidelity & Surety Co., 51 Phil. 57 [1927]; see Alaras vs. Court of Appeals, 64 SCRA 671 [1975]; Cunanan vs. Antepasado, 5 SCRA 1028 [1962]; Dizon vs. Gaborro, 83 SCRA 688 [1978].)

"Relief by way of reformation of a written agreement will not be granted unless the proof of mutual mistake is of the clearest and the most satisfactory character. The amount of evidence necessary to sustain a prayer for relief where it is sought to impugn a fact in a document is always *more than a mere preponderance of evidence."* (Vda. de Gonzales Mondragon vs. Santos, 87 Phil. 471 [1950].)

ILLUSTRATIVE CASES:

1. *Mutual mistake was made in designating the property sold in written contract of sale.*

*Facts:* S sold to B lot No. 5 which was erroneously designated as lot No. 10 in the deed of sale. Subsequently, S sold to C lot No. 10 which, through mistake, was designated as lot No. 5 in the deed of sale. B and C occupied the lots respectively sold to them.

*Issue:* Is reformation proper?

*Held:* Yes. Here, there is simple mistake in drafting the documents of sale. Reformation is proper, there being a meeting of the minds of the parties to their contracts. "One sells or buys property as he sees it, in its actual setting and by its physical metes and bounds, and not by the mere lot number assigned to it in the certificate of title."

In this case, however, the deeds of sale need not be reformed. Having retained possession of their respective properties conformably to the real intention of the parties, all that B and C should do is to execute mutual deeds of conveyance.[4] (*Atilano vs. Atilano, 28 SCRA 231 [1969];* Dihiansan vs. Court of Appeals, 153 SCRA 712 [1987].)

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2. *Indorsee of promissory note seeks reformation of instrument of guaranty in favor of maker on ground of mutual mistake by substituting indorsee for maker.*

*Facts:* M (maker) executed a promissory note in favor of P (payee). S (surety) made a notation on the note obligating itself, for value received, "to hold M harmless against loss for having discounted the note." P indorsed the note to B (bank). After maturity of the note, demand was made by B on M, P, and S, all of whom refused to pay. M, being insolvent, B now seeks the reformation of the instrument of guaranty upon the ground of mutual mistake, by substituting B for M.

The correspondence between the parties and the exhibits presented failed to disclose either an express or implied admission that S had executed the guaranty in question for the protection of B (bank).

*Issue:* Is the reformation of the instrument justified?

*Held:* No. To justify reformation, upon the ground of mistake, the concurrence of the requisites mentioned are necessary. B has not established by clear and convincing evidence that there was a mutual mistake. *(Bank of P.I. vs. Fidelity & Surety Co., 51 Phil. 57 [1927].)*

[4]The parties can simply execute a deed of exchange.

**ART. 1362. If one party was mistaken and the other acted fraudulently or inequitably in such a way that the instrument does not show their true intention, the former may ask for the reformation of the instrument.**

### Unilateral mistake as basis for reformation.

Reformation is granted when the mistake is mutual. Clearly, a unilateral mistake in the making of an agreement, of which the other party is entirely ignorant and to which he in no way contributes, will not affect the agreement or afford ground for its reformation.

In other words, a party to a contract cannot avoid it on the ground that he made a mistake where there has been no misrepresentation, there is no ambiguity in the terms of the contract, and the other party has no notice of such mistake and acts in perfect in good faith. A unilateral mistake accompanied by other facts (see Arts. 1362, 1363.) may be sufficient, however. (see 12 Am. Jur. 624-625.)

### Mistake on one side, fraud or inequitable conduct on the other.

Under Article 1362, the right to ask for reformation is granted only to the party who was mistaken in good faith. Here, the mistake is not mutual.

ILLUSTRATIVE CASE:

*Condition of repurchase was fraudulently omitted by vendee from deed of sale with pacto de retro.*

*Facts:* S sold a parcel of land to B with the understanding that the sale was subject to S's right to repurchase. With the help of a lawyer, B had the deed prepared in the English language with which S was unfamiliar. The deed did not include the condition of repurchase which fact was known to B.

Before S signed the deed, he inquired whether it contained said condition and he was told by B that it was sufficient. S relied upon the statement of B as to the contents and effect of the deed. Later, when S demanded the reconveyance of the property, B refused on the ground that he was the absolute owner of the same.

*Issue:* Is S entitled to reformation?

*Held:* Yes. S was mistaken. The conduct of B amounts to fraud or unfair dealing which warrants the reformation of the instrument. *(Ong Chua vs. Carr, 53 Phil. 975 [1929].)*

**ART. 1363. When one party was mistaken and the other knew or believed that the instrument did not state their real agreement, but concealed that fact from the former, the instrument may be reformed.**

### Concealment of mistake by other party.

The remedy of reformation may be availed of only by the party who acted in good faith. The concealment of the mistake by the other party constitutes fraud.

**ART. 1364. When through the ignorance, lack of skill, negligence or bad faith on the part of the person drafting the instrument or of the clerk or typist, the instrument does not express the true intention of the parties, the courts may order that the instrument be reformed.**

### Ignorance, etc. on the part of third person.

Under the above article, neither party is responsible for the mistake. Hence, either party may ask for reformation.

Thus, in a case, the court allowed the reformation of a letter written by the plaintiff (contractor) to the defendant, which affirmed a verbal contract between the plaintiff and the defendant relating to the construction of certain buildings, by substituting the dollar ($) sign for the peso (P) sign, it appearing that in said letter, by clerical error and unknown to the plaintiff, the latter sign was used instead of the former and the defendant knew or should have known in the very nature of things that no sane, responsible man would submit a deed to construct the buildings in question at the price in pesos. (Manila Engineering Co. vs. Cranston and Heacock, 45 Phil. 128 [1923].)

**ART. 1365. If two parties agree upon the mortgage or pledge of real or personal property, but the instrument states that the property is sold absolutely or with a right of repurchase, reformation of the instrument is proper.**

### Mortgage or pledge stated as a sale.

Under this article, the reformation of the instrument is proper, otherwise, the true intention of the parties would be frustrated. Such true intention must prevail for the contract must be complied with in good faith. (Art. 1159.)

When any of the circumstances enumerated in the law exists, an instrument purporting to be a sale with right of repurchase shall be presumed to be an equitable mortgage.[5]

**ART. 1366. There shall be no reformation in the following cases:**

**(1) Simple donations *inter vivos* wherein no condition is imposed;**

**(2) Wills;**

**(3) When the real agreement is void.**

**ART. 1367. When one of the parties has brought an action to enforce the instrument, he cannot subsequently ask for its reformation.**

### Cases when reformation not allowed.

(1) *Simple donations inter vivos where no condition is imposed.* — Donation is an act of liberality whereby a person disposes gratuitously of a thing or right in favor of another, who accepts it. (Art. 725.) When the donor intends that the donation shall take effect during his

[5]Art. 1602. The contract shall be presumed to be an equitable mortgage, in any of the following cases:

(1) When the price of a sale with right to repurchase is unusually inadequate;

(2) When the vendor remains in possession as lessee or otherwise;

(3) When upon or after the expiration of the right to repurchase another instrument extending the period of redemption or granting a new period is executed;

(4) When the purchaser retains for himself a part of the purchase price;

(5) When the vendor binds himself to pay the taxes on the thing sold;

(6) In any other case, where it may be fairly inferred that the real intention of the parties is that the transaction shall secure the payment of a debt or the performance of any other obligation.

In any of the foregoing cases, any money, fruits, or other benefit to be received by the vendee as rent or otherwise shall be considered as interest which shall be subject to the usury laws. (n)

Art. 1604. The provisions of Article 1602 shall also apply to a contract purporting to be an absolute sale. (n)

lifetime, it is a donation *inter vivos.* It is distinguished from donation *mortis causa* in that this kind of donation takes effect after the donor's death.

(a) In donation, the act is essentially gratuitous and the donee has, therefore, no just cause for complaint. If in the deed of donation, a mistake or defect has been committed, it is a mere failure in a bounty which, as the donor was not bound to make, he is not bound to correct. (see 45 Am. Jur. 599.) Of course, the donor may ask for the reformation of a deed of donation.

(b) If the donation is conditional or is onerous in character, the deed may be reformed so that the true conditions imposed by the donor or the real intention of the parties might be expressed. (see Phil. National Railways vs. CFI of Albay, 83 SCRA 569 [1978].)

(2) *Wills.* — A *will* is an act whereby a person is permitted with the formalities prescribed by law to control to a certain degree the disposition of his estate, to take effect after his death. (Art. 783.)

Like a donation, the making of a will is a strictly personal and a free act which cannot be left to the discretion of a third person (see Art. 784.); hence, upon the death of the testator, the right to reformation is lost.[6] Furthermore, a will may be revoked by the testator any time before his death and this right is not subject to waiver or restriction. (see Art. 828.)

(3) *Where the real agreement is void.* — If the real agreement is void, there is nothing to reform. Reformation would be useless because the real agreement being void, it is unenforceable.

(4) *Where one party has brought an action to enforce the instrument.* — Article 1367 is based on estoppel (Art. 1431.) or ratification. (see Arts. 1392, 1396.) When a party brings an action to enforce the contract, he admits its validity and that it expresses the true intention of the parties. The bringing of the action is thus inconsistent with reformation. There is no prohibition against joining in one action the reformation of instrument and its enforcement as reformed.

[6]Article 789 may be considered as an exception. It provides: "When there is an imperfect description, or when no person or property exactly answers the description, mistakes and omissions must be corrected, if the error appears from the context of the will or from extrinsic evidence, excluding the oral declarations of the testator as to his intention. x x x."

**ART. 1368. Reformation may be ordered at the instance of either party or his successors in interest, if the mistake was mutual; otherwise, upon petition of the injured party, or his heirs and assigns.**

### Party entitled to reformation.

The above article enumerates the persons who can bring an action to reform an instrument:

(1) Either of the parties, if the mistake is mutual under Articles 1361, 1364, and 1365;

(2) In all other cases, the injured party, under Articles 1362, 1363, 1364, and 1365; and

(3) The heirs or successors in interest, in lieu of the party entitled. (Art. 1368.)

The effect of reformation is retroactive from the time of the execution of the original instrument.

**ART. 1369. The procedure for the reformation of instruments shall be governed by rules of court to be promulgated by the Supreme Court.**

### Procedure for reformation.

The Rules of Court govern procedure. However, the Supreme Court has not as yet promulgated the procedure for the reformation of instruments. (see Sec. 7, Rule 130, Rules of Court.)

As a general rule, all persons interested in the subject matter of litigation, whether it is a legal or an equitable interest should be made parties in suits to reform written instruments, so that the court may settle all of their rights at once and thus, prevent the necessity of a multiplicity of suits. Thus, in an action to reform a deed of sale, all parties claiming an interest in the property or any part thereof purportedly conveyed by the instrument sought to be reformed and whose interests will be affected by the reformation of the instrument are necessary parties to the action. (Toyota Motor Philippines Corp. vs. Court of Appeals, 216 SCRA 236 [1992].)

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# Chapter 5

# INTERPRETATION OF CONTRACTS

### Meaning of interpretation of contracts.

*Interpretation of a contract* is the determination of the meaning of the terms or words used by the parties in their contract.

Determining the intent of the parties is usually what courts say it is when they interpret a contract's language in particular cases.

### Interpretation of a contract, a question of law.

Interpretation of a contract involves a question of law since a contract is in the nature of law as between the parties and their successors in interest. (Melliza vs. City of Iloilo, 23 SCRA 477 [1968]; see Art. 1159.)

### Interpretation and reformation distinguished.

Interpretation is the act of making intelligible that was not before understood, ambiguous, or not obvious. It is a method by which the meaning of language is ascertained.

On the other hand, reformation is that remedy in equity by means of which a written instrument is made or construed so as to express or conform to the real intention of the parties. (Chap. 4.) In granting reformation, therefore, equity is not really making a new contract for the parties but is conforming and perpetuating the "real contract" between them which under the technical rules of law, could not be enforced but for such reformation.

As a general rule, parol evidence is not admissible for the purpose of varying the terms of a contract. However, when the issue that a

contract does not express the intention of the parties, and the proper foundation is laid therefor, the court should hear the evidence for the purpose of ascertaining the true intention of the parties. Thus, where the complaint raises the issue that a contract of lease does not express the true intention of the parties due to the mistake on the part of the plaintiff and fraud on the part of the defendant, the court should conduct a trial and receive evidence of the parties for the purpose of ascertaining such intention when they executed the instrument in question. (National Irrigation Administration vs. Gamit, 215 SCRA 436 [1992]; Huibonhoa vs. Court of Appeals, 320 SCRA 625 [1999]; Sabio vs. International Corporate Bank, Inc., 364 SCRA 385 [2001].)

The rule is that he who alleges that a contract does not reflect the true intention of the parties thereto is burdened to prove by clear and convincing evidence such intention. The presumption is that a contract is what is purports to be.

**Laws, in general, as aid to interpretation of contracts.**

Before examining the different rules of interpretation given by the Code, it may be advisable to emphasize that there is a body of rules which regulates each contract, or all contracts in general. This fundamental point should not be forgotten, because it decides the problem of interpretation and solves deficiency and omission in many cases.

(1) *Modification by parties of rules of interpretation.* — The parties are free to accept these rules as a whole, or to modify in cases not essential or obligatory, or to complete to the extent which is legal or in conformity with their nature.

(2) *Acceptance by parties of the rules.* — These suppletory norms, these legal models must be presumed to have been accepted if nothing is said to the contrary and, therefore, the contract must be deemed complete, and its deficiency supplied from the beginning, probably without the necessity of interpretation. Thus, with the simple agreement upon the thing and price in a contract of sale, the various incidents which may arise in its performance under ordinary conditions, are deemed tacitly subject to the provisions of the law.

(3) *Natural and accidental elements of contract.* — The acceptance of the natural elements of contract is implied, when nothing is said by the

parties to the contrary, and the exclusion of the accidental elements, if none has been stipulated by them — a distinction which has already been indicated in connection with Article 1318 and which is sanctioned by jurisprudence. (see G. Florendo, *supra,* pp. 775-776, citing 8 Manresa 724, 725.)

Conditions precedent are not favored. Unless impelled by plain and unambiguous language or by necessary implication, courts will not construe a stipulation as laden with such burden, particularly when that stipulation would result in a forfeiture or in inequitable consequences. (Phil. National Bank vs. RBL Enterprises, Inc., 430 SCRA 299 [2004].)

(4) *Intent of the law.* — It is a cardinal rule that in seeking the meaning of the law, the first concern of the court should be to discover in its provisions the intent of the lawmaker. The law should never be interpreted in such a way as to cause injustice as this is never within the legislative intent. To be sure, there are some laws that, while generally valid, may seem arbitrary when applied in a particular case because of its peculiar circumstances. In such a situation, the court is not bound to apply them just the same in slavish obedience to their language. Its duty is to find a balance between "the word and the will," that justice may be done even as the law is obeyed. (Alonzo vs. Intermediate Appellate Court, 150 SCRA 259 [1987].)

(5) *Retroactivity of the law*. — Well-settled is the rule that statutes have no retroactive effect unless otherwise provided therein. Only laws existing at the time of the execution of the contract are applicable to said transaction. (Phil. Virginia Tobacco Adm. vs. Gonzales, 92 SCRA 172 [1979].)

(6) *Law of place where contract entered into.* — According to the doctrine of *lex loci contractus*, as a general rule, the law of the place where a contract is made or entered into governs with respect to its nature, validity, obligation, and interpretation. This has been the rule even though the place where the contract was made is different from the place where it is to be performed. Thus, in a case, Philippine law was held applicable where the airline tickets were purchased by respondent through petitioner's agent in Manila although the contract of passage was to be performed in the United States, and not withstanding that the tickets were "rewritten" in Washington, D.C. because such fact did not change the nature of the original contract of passage entered into

by the parties in Manila. (United Airlines, Inc. vs. Court of Appeals, 357 SCRA 99 [2001]; Zalamea vs. Court of Appeals, 228 SCRA 23 [1993].)

**ART. 1370. If the terms of a contract are clear and leave no doubt upon the intention of the contracting parties, the literal meaning of its stipulations shall control.**

**If the words appear to be contrary to the evident intention of the parties, the latter shall prevail over the former. (1281)**

### Literal meaning controls when language clear.

Valid and enforceable contracts, being the private laws of the contracting parties, should be fulfilled according to the literal sense of their stipulations as they appear on the face of the contract. The words used therein should be given their natural and ordinary meaning unless a technical meaning was intended.

If the terms of a contract are clear and unequivocal, the parties are bound thereby. (Phil. Am. Gen. Ins. Co., Inc. vs. Mutuc, 61 SCRA 22 [1972]; Castro vs. Court of Appeals, 99 SCRA 722 [1980].) In this case, the question is not what existed in the minds of the parties but what intention is expressed in the language used. (17 C.J.S., 700; see Vda. de Gonzales vs. Santos, 87 Phil. 471 [1950]; Republic vs. Vda. de Castellvi, 58 SCRA 336 [1974].) No amount of extrinsic facts or aids are required and no further extraneous sources are necessary in order to ascertain the parties' intent. (Inter-Asia Services Corp. vs. Court of Appeals, 263 SCRA 408 [1996].) Neither abstract justice nor the rule on liberal interpretation justifies the creation of a contract for the parties which they did not make for themselves. (JMA House, Inc. vs. Sta. Monica Industrial & Dev. Corp., 500 SCRA 526 [2006]; Mercado vs. Allied Banking Corporation, 528 SCRA 444 [2007].) Their intention must be gathered from the language of the contract and from that language alone. (Bautista vs. Court of Appeals, 322 SCRA 365 [2000]; Abad vs. Goldloop Properties, Inc., 521 SCRA 131 [2004].) Such contracts do not need to be construed. (Commissioner of Internal Revenue vs. Cadwallader Pacific Co., 73 SCRA 59 [1976]; see also De Cortes vs. Venturanza, 79 SCRA 709 [1976]; San Mauricio Mining Co. vs. Ancheta, 105 SCRA 371 [1981]; Matienzo vs. Servidad, 107 SCRA 276 [1981]; Leveriza vs. Intermediate Appellate Court, 157 SCRA 282 [1988].)

(1) For example, the provision in a contract giving the vendor the right to repurchase the property sold "after two (2) years from and after the execution of this contract" simply means the vendor can redeem the property after two (2) years and not that the right must be exercised within that two-year period from the date of the execution of the contract. (Badayos vs. Court of Appeals, 207 SCRA 209 [1992].)

(2) In a case where the sellers declared in the "Receipt of Down Payment" that they received from the buyer "the sum of P50,000.00 purchase price of our inherited house and lot x x x, in the total amount of P1,240,000.00," without any reservation of title until full payment of the entire purchase price, the natural and ordinary idea conveyed is that they sold their property. (Coronel vs. Court of Appeals, 263 SCRA 15 [1996].)

(3) In another case, petitioner expressly bound herself to "be jointly and severally or solidarily liable" with the principal maker of a promissory note. Having entered into the contract with full knowledge of its terms and conditions, she was held estopped to assert that she did so under a misapprehension or in ignorance of their legal effect, or as to the legal effect of the undertaking. The terms of the contract she signed are clear, explicit and unequivocal that her liability is that of surety and not of guarantor. (Palmares vs. Court of Appeals, 288 SCRA 422 [1998].)

(4) The term "and/or" has been held to mean that effect shall be given to both the conjunctive "and" and disjunctive "or;" or that one or the other may be taken accordingly as one or the other will best effectuate the intended purpose. In using the term "and/or" the two words are to be used interchangeably. (Amon Trading Corporation vs. Court of Appeals, 477 SCRA 522 [2006].)

**Weight of evidence to justify disregard of contracts.**

(1) *Terms presumed to embody will of parties.* — It is to be presumed that every contracting party knows the contents of the contract before he signs and delivers it and that the words used embody the will of the parties. Consequently, neither of them, when he sues or is sued on it, should be permitted to deny that the contract expresses the agreement they undertook. Otherwise, a dangerous precedent would be established and the value of all contracts would be destroyed. (Tan Tua Sia vs. Yu Biao Sontua, 56 Phil. 711 [1932].)

It is the duty of every contracting party to learn and know the contents of a document before he signs and delivers it. (Conde vs. Court of Appeals, 119 SCRA 245 [1982].)

(2) *Clear and convincing evidence required to impugn a contract.* — Where the terms of the contract are simple and clear and it appears to have been executed with all the solemnities of the law, more than a mere preponderance of evidence is required to successfully impugn it. (Mendozona vs. Phil. Sugar Estates Dev. Co. and De Garay, 41 Phil. 475 [1921]; Bank of P.I. vs. Fidelity and Surety Co., 51 Phil. 57 [1927].) To justify disregarding the legal effects and consequences of contracts formally and voluntarily entered into, the evidence must be clear and convincing. (Development Bank of the Phil. vs. National Merchandising Corp., 40 SCRA 624 [1971].)

**Application and interpretation of terms of contracts by courts.**

(1) *First duty of court.* — It is error on the part of the court to make room for interpretation or construction of the provisions of a contract when the case plainly calls for application thereof. (Henson vs. Intermediate Appellate Court, 148 SCRA 11 [1987].) The first and fundamental duty of the court is the application of the contract according to its express terms, interpretation being called only when such literal application is impossible. (see Pacific Oxygen & Acetylene Co. vs. Central Bank of the Phil., 22 SCRA 917 [1968].) Being the primary law between the parties, it governs the adjudication of their rights and obligations. (Felsan Realty & Dev. Corp. vs. Commonwealth of Australia, 535 SCRA 618 [2007].), otherwise, the court runs the risk of substituting its own interpretation for the true intent of the parties.

It is only when the terms of the contract are ambiguous, equivocal, or uncertain such that the parties themselves disagree upon the meaning of particular provisions, that the court will intervene. (Pan Malayan Insurance Corp. vs. Court of Appeals, 184 SCRA 54 [1990].) A contract provision is ambiguous if it is susceptible of two reasonable alternative interpretations. In such case, the interpretation is left to the court to resolve the ambiguity. But where language of a contract is plain and unambigious, its meaning should be determined without reference to extrinsic facts or aids. (Abad vs. Goldloop Properties, Inc., 521 SCRA 131 [2004]; Bautista vs. Court of Appeals, 322 SCRA 365 [2000].)

(2) *Limits to interpretation.* — Courts are not permitted to make a new contract for the parties in ascertaining their intention or ignore those already made by them simply to avoid seeming hardships. Their function and duty are confined to the interpretation of the contract which the parties have made for themselves, without regard to its wisdom or folly, as the court cannot supply material stipulations or read into a contract words which it does not contain.[1] (Bacolod-Murcia Co., Inc. vs. Banco Nacional Filipino, 74 Phil. 675 [1944]; Gindoy vs. Tapucar, 75 SCRA 31 [1977]; Union Manufacturing Co., Inc. vs. Phil. Guaranty Co., Inc., 47 SCRA 271 [1972]; Alcuaz vs. Phil. School of Business Adm., 161 SCRA 7 [1988]; Gaw vs. Court of Appeals, 487 SCRA 423 [2006].)

(3) *Equity as ground for relief against a bad transaction.* — Equity is not an antidote against the disadvantages of a bad transaction, and it may not be invoked to allow a contract to be interpreted in a manner different from that impelled by its terms. If a party believes that the contract does not express the true intention of the parties thereto, his remedy is to ask for reformation of the same in accordance with Articles 1359, etc. of the Civil Code. (Ledesma vs. Javellana, 121 SCRA 794 [1983].)

(4) *Submission of disputes to arbitration.* — Being an inexpensive, speedy and amicable method of settling disputes, arbitration — along with mediation, conciliation and negotiation — is encouraged by the Supreme Court. Consistent with this policy, courts should liberally construe arbitration clauses. Any doubt should be resolved in favor of alternative dispute resolution methods. (LM Power Engineering Corp. vs. Capitol Industrial Construction Groups, Inc., 399 SCRA 562 [2003].)

ILLUSTRATIVE CASES

1. *Defendant promised to "use all the means within his power to effect the redemption."*

*Facts:* S agreed to accomplish the redemption of certain parcels of land from their respective purchasers, "with the cooperation of B who will use all the means within his power to effect the redemption." The redemption became legally impossible, because some parcels were sold

[1]Article 1267 authorizes the *release* not a modification or revision of the terms of the contract of a party from his obligation under a contract.

in absolute sale, and as regards the other parcels, the right to redeem them had already been extinguished.

*Issue:* Should it be considered that B has already violated his obligation?

*Held:* No. The literal wording of the contract itself shows that S is the one who bound himself to make the redemption and that B only promised to cooperate with S towards this purpose. The promise of B should be interpreted as obligating him only to cooperate in the redemption of the property. It is sufficient that he should use all the means within his power to effect the same. *(Ferrer vs. Ignacio, 39 Phil. 446 [1918].)*

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2. *Vendor sold "all his rights etc. whether accrued or acruing in his pro indiviso share" in a property.*

*Facts:* Upon the death of X, lessee of a hacienda, Y filed a claim against his estate in the amount of P65,000.00 "as the money value of sugar allotments and allowances" appertaining to Y's half-share in the *hacienda* which amount, X, appropriated to himself. It appeared, however, that, before the death of X, Y sold "all his rights, title, interest, and participation, whether accrued or accruing in his *pro indiviso* share" in the hacienda, "together with all the improvements now existing thereon, including its sugar quota," in favor of his co-owner B.

*Issue:* Does the phrase "accrued or accruing" (in the deed of sale) having reference to Y's rights in the plantation include the sugar allotments and allowances adherent to the hacienda?

*Held:* Yes. It is immaterial that X was not the vendee since what mattered is that Y parted with his accrued rights for a valuable consideration. The words "accrued or accruing" in the deed of sale are not obscure, and are in fact positive and categorical enough to include all benefits accrued and accruing to Y before the sale. Since the words are not ambiguous, there is no need to interpret them. *(Ereneta vs. Bezore, 54 SCRA 13 [1973].)*

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3. *An employee may still enjoy his earned trip pass if his separation from the service is "for reasons other than for cause."*

*Facts:* The collective bargaining agreement between PAL and PALEA provides, among others, that "an employee separated from the service for reasons other than for cause may take advantage of his earned trip pass x x x within 90 days from date of termination x x x." X, a PAL employee, was entitled to a plane ticket as part of trip pass privilege under the

agreement. However, he was involved in a strike, the legality of which was under consideration by the then Court of Industrial Relations. X was among those directed by the court not to report for work pending decision of the issue.

*Issue:* Does the quoted provision of the collective bargaining agreement sanction the suspension of the trip pass privilege of X who is entitled to the same once he is on leave?

*Held:* No. The language of the agreement is crystal clear and is not susceptible of other interpretations. *(Phil. Air Lines, Inc. vs. Phil. Air Lines Employees Assoc. [PALEA], 70 SCRA 180 [1976].)*

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4. *The lease contract is for a period of 20 years "being extendible" for another period of 20 years.*

*Facts*: J leased a portion of her property to spouses V and F for a period of 20 years "automatically extended" for another 20 years but with increased rental of P220.00 a month. Subsequently, a new lease contract was entered into between J and R, to whom the spouses sold their leasehold rights, "for a period of 20 years from and after [April 1, 1962], will a monthly rental of P180.00 payable in advance said period *being extendible* for another period of 20 years with a monthly rental of P220.00 also payable in advance on or before the 1st day of each month."

It is the contention of petitioner, predecessor-in-interest of J that to extend the lease contract for another 20 years requires a subsequent agreement between the parties as the phrase "being extendible" meant "capable of being extended."

On the other hand, private respondents, heirs of R, argue that the terms of the lease contract are clear and that the same should be automatically extended upon the expiration of the first 20 years.

The court *a quo*, however, gave merit to the contention of herein private respondents and said:

"To enter into new negotiations to extend the contract would, therefore, be superfluous and unnecessary, an idle ceremony, for the lease contract already contains all that is necessary for the extension thereof. x x x

The suggestion to enter into new negotiations run counter to the lease contract for, as already said, everything necessary for its renewal or extension has been agreed upon. All that was left was to abide by the lease contract. x x x"

*Issue*: Whose contention should be upheld, that of the petitioner or that of the private respondents?

*Held*: (1) *First lease contract clear and unambiguous.* — "Inasmuch as both the parties to the lease contract have already died, a resort to the terms and conditions of the lease contract is inevitable in order to ascertain the true intent of the parties.

In a wealth of cases and as provided for in Articles 1370 and 1372 of the Civil Code, we have ruled that when the terms and stipulations embodied in a contract are clear and leave no room for doubt, such should be read in its literal sense and that there is absolutely no reason to construe the same in another meaning.

Thus, the lease contract executed between Esperanza Jose and spouses Eugenio Vitan and Beatriz Francisco on July 12, 1957, being clear and unambiguous, providing for an automatic extension of twenty (20) years from the expiration of the first twenty (20) years, there is no reason why said contract should not be interpreted in the way the contracting parties meant it to be, that is the automatic extension of the lease for another twenty (20) years. Thus, paragraph 3 of the contract reads:

3. That the period of TWENTY YEARS (20) herein above provided shall be automatically extended for another TWENTY YEARS (20) but with the rental of TWO HUNDRED AND TWENTY PESOS (P220.00) per month payable also in advance on or before the 1st day of each corresponding month, at the residence of the Party of the First part."

(2) *Automatic extension of lease not intended in second lease contract.* — "The same could not be said in the case at bar. The phrase automatically extended did not appear and was not used in the lease contract subsequently entered into by Esperanza Jose and Augusto Reyes, Jr. for the simple reason that the lessor does not want to be bound by the stipulation of automatic extension as provided in the previous lease contract.

To our mind, the stipulation 'said period of lease being extendable for another period of twenty (20) years x x x' is clear that the lessor's intention is not to automatically extend the lease contract but to give her time to ponder and think whether to extend the lease. If she decides to do so, then a new contract shall be entered into between the lessor and lessee for a term of another twenty (20) years and a monthly rental of P220.00. This must be so, for twenty (20) years is rather a long period of time and the lessor may have other plans for her property.

If the intention of the parties were to provide for an automatic extension of the lease contract, then they could have easily provided for

a straight forty (40) years contract instead of twenty." *(Santi vs. Court of Appeals, 227 SCRA 541 [1993].)*

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5. *Contractor denies that the construction of a deep well was included in the agreement to build a windmill system.*

*Facts:* T (petitioner) proposed to H to construct a windmill system for him. There were in fact two letter-proposals and it was the second proposal with a lower contract price of P60,000.00 that was accepted by H.

The pertinent portions of both proposals are reproduced hereunder.

"In connection with your Windmill System and Installation, we would like to quote to you as follows:

One (1) Set — Windmill suitable for 2 inches diameter deep well x x x."

"In connection with your Windmill system, Supply of Labor Materials and Installation, operated water pump, we would like to quote to you as follows:

One (1) set — Windmill assembly for 2 inches or 3 inches deep well pump x x x."

*Issue:* Is the construction of the deep well part of the windmill system?

*Held:* No. (1) *No mention that such construction is included.* — "Nowhere in either proposal is the installation of a deep well mentioned, even remotely. Neither is there an itemization nor description of the materials to be used in constructing the deep well. There is absolutely no mention in the two (2) documents that a deep well pump is a component of the proposed windmill system. The contract prices fixed in both proposals cover only the features specifically described therein and no other.

(2) *Terms of both proposals clear as to their meaning.* — "While the words, *'deep well'* and *'deep well pump'* are mentioned in both, these do not indicate that a deep well is part of the windmill system. They merely describe the type of a deep well pump for which the proposed windmill would be suitable. As correctly pointed out by petitioner, the words *'deep well'* precedent by the prepositions *'for'* and *'suitable for'* were meant only to convey the idea that the proposed windmill would be appropriate for a deep well pump with a diameter of 2 to 3 inches. For if the real intent of petitioner was to include a deep well in the agreement to construct a windmill, he would have used instead the conjunctions *'and'* or *'with.'*

Since the terms of the instruments are clear and leave no doubt as to their meaning they should not be disturbed." *(Tanguilig vs. Court of Appeals, 266 SCRA 78 [1997].)*

**Evident intention of parties prevails over terms of contract.**

(1) *Where terms in conflict with manifest intention.* — When the words of a contract are clear and readily understandable, there is no room for construction. (Vda. de Macoy vs. Court of Appeals, 206 SCRA 244 [1992].) Such words are to be understood literally, just as they appear on the face of the contract. However, where the words and clauses of a written contract appear to conflict or contravene with the manifest intention of the parties, the latter shall prevail over the former. For example, the use of the term "guarantee" does not *ipso facto* make the contract one of guaranty, where the word "guarantor" is qualified by the term "jointly and severally" to refer to a "surety" whose liability is direct, primary, and absolute. (International Finance Corporation vs. Imperial Textile Mills, Inc., 475 SCRA 149 [2006].)

It is a cardinal rule in the interpretation of contracts that the intention of the contracting parties should always prevail because their will has the force of law between them. (Kasilag vs. Rodriguez, 69 Phil. 217 [1939]; see Borromeo vs. Court of Appeals, 47 SCRA 65 [1972]; Reyes vs. Limjap, 15 Phil. 420 [1910]; De La Vega vs. Ballilos, 35 Phil. 683 [1916]; Sy vs. Court of Appeals, 131 SCRA 116 [1984]; Cuizon vs. Court of Appeals, 260 SCRA 645 [1996].) All other rules are but auxiliary to the ascertainment of the meaning intended by the parties. (Ligon vs. Court of Appeals, 177 SCRA 64 [1989].)

(2) *Determination by court of true intention.* — The words used by the parties to project that intention, all the words not just a particular word or two, and words in context not words standing alone, must be looked into. (Fernandez vs. Court of Appeals, 166 SCRA 877 [1988].) Once the true intention of the parties has been ascertained and determined, it becomes integral part of the contract as though it has been originally expressed therein in unequivocal terms and binds them without the need of extraneous evidence. (Ligon vs. Court of Appeals, *supra*; Carciller vs. Court of Appeals, 302 SCA 718 [1999].)

The problem, however, is that the parties will often differ as to the meaning of the words or phrases used and argue over whose interpre-

tation should control. Thus, it often becomes necessary for a court to determine a contract's meaning from the language used in the contract and the conduct or acts of the parties.

EXAMPLES:

(1) S sold to B a parcel of agricultural land. It is not disputed that the reasonable value of the land is P50,000.00. However, the contract of sale states that the purchase price is P500,000.00.

In this case, as the amount of P500,000.00 appears to be contrary to the evident intention of the parties, the latter shall prevail.

(2) R entered into a contract called "contract of lease" with E whereby R leased his car to E. It is stipulated that E, shall pay P100,000.00, upon the signing of the contract, and P500.00, by way of "rental" on or before the 5th day of every month; and that at the end of one year, E would become the absolute owner of the car. The contract fixed the value of the car to be P160,000.00.

There can hardly be any question that the contract is not a lease of the car but a sale in installments. (see Abella vs. Gonzaga, 56 Phil. 132 [1931]; Manila Gas Corp. vs. Calupitan, 66 Phil. 646 [1938]; U.S. Commercial vs. Halili, 93 Phil. 271 [1953]; see Arts. 1484, 1485.) The so-called rent must necessarily be regarded as payment of the price in installments inasmuch as the due payment of the agreed amount results, by the terms of the bargain, in the transfer of title to E, the alleged lessee. (see Vda. de Jose vs. Veloso Barrueco, 67 Phil. 191 [1939].)

ILLUSTRATIVE CASE:

*Vendee a retro shall have the first opportunity to repurchase the land sold "at P1,500.00 per hectare."*

*Facts:* A deed of sale with *pacto de retro* contains a stipulation that B (vendee *a retro*) "shall be given the first opportunity to buy the land under the condition that the price for the same shall be at the rate of P1,500.00 per hectare." S (vendor *a retro*) sold the land to C at a price considerably much higher than P1,500.00.

*Issue:* Did S violate the above stipulation?

*Held:* No. Said stipulation must be strictly construed to mean that if the best price obtainable by S was P1,500.00 per hectare, then B must be given the first opportunity to buy the land, otherwise, if the price offered by any prospective buyer was more than or above P1,500.00 per hectare, S was not under obligation to sell the land to B.

It would be contrary to common sense and ordinary prudence to construe that under the stipulation in question, the parties intended that the price of the land be pegged or tied to a specified price per hectare when it is of general knowledge that the value of real property tends always to rise specially in the particular area in question (which is Los Baños, Laguna), which is a highly agricultural region and a most valued health resort community. *(Gardner vs. Court of Appeals, 80 SCRA 399 [1977].)*

**ART. 1371. In order to judge the intention of the contracting parties, their contemporaneous and subsequent acts shall be principally considered. (1282)**

## Contemporaneous and subsequent acts to be principally considered.

While intentions involve a state of mind which may sometimes be difficult to decipher, the acts of the parties as well as the evidentiary facts as proved and admitted can be reflective of one's intention. (Sarming vs. Dy, 383 SCRA 131 [2002].) The real nature of a contract may be determined not only from the express terms of the written agreement but also by all the surrounding circumstances to prove the intention of the parties thereto.

(1) Where the parties to a contract have given a practical construction to the terms thereof by their contemporaneous or subsequent conduct, as by acts in partial performance, such interpretation may be considered by the court in determining its meaning and ascertaining the intention of the parties (17 C.J.S. 755; see Lim Yhi Luya vs. Court of Appeals, 99 SCRA 668 [1980]; Prudential Bank & Trust Co. vs. Community Builders Co., Inc., 165 SCRA 285 [1988]; Javier vs. Court of Appeals, 183 SCRA 171 [1990]; Caltex [Phils.], Inc. vs. IAC, 215 SCRA 580 [1992].) when such intention cannot clearly be ascertained from the words used in their contract. (Art. 1370, par. 2.)

(2) The courts are not bound to rely upon the name or title given the contract by the parties. *(infra.)* The essence of the contract determines what law should apply between the contracting parties. (American Rubber Co. vs. Collector of Internal Revenue, 64 SCRA 569 [1975]; Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995]; Ching Sen Ben vs. Court of Appeals, 314 SCRA 762 [1999].)

ILLUSTRATIVE CASES:

1. *A party was given the option "after the exploration" of the mineral claims belonging to another to purchase or not to purchase the property and the understanding was that the first party was under obligation to conduct the exploration.*

*Facts:* S was the owner of the claim over certain gypsum deposits. For and in consideration of 100,000 bags of cement, B (Cepoc) executed an option to purchase said claims. The option contained the following stipulation: "That in case B, after the exploration, decides not to continue the negotiation to purchase the property, S (seller) shall refund the amount equivalent to the cost of 100,000 bags of cement. In case B decides to continue to purchase, the 100,000 bags of cement shall be considered as part of the consideration."

B delivered 99,000 bags of cement to S but did not conduct any exploration of the claim. Later, B demanded the payment of the value of the 99,000 bags of cement.

*Issue:* Is the obligation of S to pay for the cement conditioned upon an exploration being first conducted by B?

*Held:* Yes. An examination of the circumstances surrounding the execution of the contract should be taken into consideration when the express terms of the contract are not clear. From the evidence, it was the understanding of the parties that the obligation of B to make the exploration was definite and unconditional, whereas, the return of the cement was conditioned upon the completion of the exploration. *(Cebu Portland Cement Co. vs. Dumon, 61 SCRA 218 [1974].)*

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2. *The conflicting terminologies in a document create doubt as to whether it is a mere loan with security or a pacto de retro sale but the circumstances reveal the real nature of the contract.*

*Facts:* In 1927, S executed a document, which stated that needing money, he thought of selling a piece of land to B for P225, that the land could be reconveyed in 10 years, and that in the meantime S, would be responsible for all tenancy matters over the land. In 1948, S filed a complaint for the reconveyance of the property. B claimed that S had failed to exercise the right to repurchase within 10 years and, therefore, as vendee *a retro,* he had become the owner of the land.

*Issue:* Is the contention of B tenable?

*Held:* No. In view of the ambiguity caused by conflicting terminologies in the document (*viz.*: "urgent necessity for money," "selling the

land," "ownership," "I will be responsible for all tenancy matters," "this receipt is made as security.") which are sufficient to create doubt as to what the document truly purports, it becomes necessary to inquire into the reason behind the transaction and other circumstances accompanying it so as to determine the intent of the parties.

In the case at bar, the collective weight of the following considerations supported the findings and conclusion that the document is a mere loan with security and not a *pacto de retro* sale. (see Note 2, Chap. 4.)

*First*, the reason behind its execution was that S was in urgent necessity for money and had to secure a loan of P225 from B for which the riceland was given as "security."

*Second*, the amount of P225, even in 1927, was too inadequate for a purchase price of an irrigated riceland with an alleged "perimeter" of 240 meters and an "area of 1,269 square meters."

*Third*, although symbolically, the possession of the property was transferred to B, it was S, the supposed vendor, who continued to be in physical possession of the property, took charge of its cultivation, and all tenancy matters.

*Fourth*, B, the supposed vendee *a retro* never declared the property in his name for taxation purposes nor did he pay the taxes due thereon; and

*Fifth*, B failed to take any step to consolidate his alleged ownership over the land by the mere registration of an affidavit of consolidation, a judicial order not being necessary under the old Civil Code which is required now under Article 1607 of the new Civil Code. *(Labasan vs. Lacuesta, 86 SCRA 16 [1978].)*

### Antecedent circumstances relevant in determination of intention.

Although Article 1371 speaks of acts contemporaneous and subsequent (see Goñi vs. Court of Appeals, 144 SCRA 222 [1986], under Art. 1292.) to the celebration of the contract, antecedent circumstances under which it was made may also be considered. (Sec. 11, Rule 130, Rules of Court; see Bacordo vs. Alcantara, 14 SCRA 730 [1965]; Abesamis vs. Woodcraft Works, Ltd., 30 SCRA 372 [1969]; see also Calvo vs. Olives, 6 Phil. 88 [1906]; Atlantic Gulf Co. vs. Insular Gov't., 10 Phil. 166 [1908].)

It is well-settled that in construing a writing, particularly a written agreement, the reason behind and the circumstances surrounding its

execution are of paramount importance to place the interpreter in the situation occupied by the parties concerned at the time the writing was executed. (Gotamco Hermanos vs. Shotwell, 38 SCRA 107 [1971]; see Gonzales vs. La Provisora Filipina, 74 Phil. 165 [1949]; Banawa vs. Mirano, 97 SCRA 517 [1980]; Cuizon vs. Court of Appeals, 260 SCRA 645 [1996]; Ridjo Tape & Chemical Corp. vs. Court of Appeals, 286 SCRA 544 [1998]; 12 Am. Jur. 784-786.) The language of the contract is not determinative of the parties' relationship; rather it is the totality of the facts and surrounding circumstances of the case. (San Miguel Corporation vs. Aballa, 461 SCRA 392 [2005].)

ILLUSTRATIVE CASE:

*The parties for many years had understood the free ride privilege as granted only to those "wearing official badges."*

*Facts:* Under a franchise which is in the nature of a contract granted by the City of Manila for the construction and maintenance of a street railway system, employees of the police and fire departments of the city shall be entitled to ride free upon the Meralco cars. For nine (9) years, the parties had understood the provision giving the privilege of free ride as granted only to those "wearing official badges" visibly during the period of transportation.

Subsequently, the city secured an order from the Public Utility Commission an order requiring the Meralco to give the same privilege to city detectives who did not wear their badges visibly.

*Issue:* In the light of the conduct of the parties during the period of nine years, was the interpretation given to the provision correct?

*Held:* No. The construction placed by the parties to the contract on the clause under consideration must exert a powerful influence in the determination of the question presented. The construction adopted by the Commission was diametrically opposed to that which the parties have placed thereon for so long a time. *(Manila Electric Co. vs. Board of Public Utility Commissioners, 30 Phil. 387 [1915].)*

### Courts not bound by name given to contract by the parties.

To determine the true nature of a contract, courts do not have or are not bound to rely upon the name or title given it by the contracting parties should there be a controversy as to what they really intended to enter into. The way the contracting parties do or perform their

respective obligations stipulated or agreed upon may be shown and inquired into, and should such performance conflict with the name or title given the contract by the parties, the former must prevail over the latter. (Shell Co. of the Phil., Ltd. vs. Firemen's Insurance Co. of Newark, 100 Phil. 757 [1957]; Balbas vs. Domingo, 21 SCRA 444 [1967]; Borromeo vs. Court of Appeals, 47 SCRA 65 [1972]; Citizens Surety & Ins. Co. vs. Court of Appeals, 162 SCRA 738 [1988]; Tiu Peck vs. Court of Appeals, 221 SCRA 618 [1993]; Agas vs. Sabaco, 457 SCRA 263 [2005].) In fine, the denomination, or title given by the parties to their contract is not conclusive of the nature of its contents. (Valdez vs. Court of Appeals, 439 SCRA 55 [2004]; Ver Reyes vs. Salvador, Sr., 564 SCRA 456 [2008].)

Therefore, documentary and parol evidence may be submitted and admitted to prove the true intention of the parties as shown by their words, conduct and acts before, during, and immediately after the execution of the contract. (Zamora vs. Court of Appeals, 260 SCRA 10 [1996]; Lorbes vs. Court of Appeals, 351 SCRA 716 [2001; Lopez vs. Sarabia, 439 SCRA 35 [2004]; Ramos vs. Sarao, 451 SCRA 103 [2005].)

**True nature of contract defined by law.**

A contract is what the law defines it to be, considering its essential elements, and not what it is called by the contracting parties. (Schmid and Aberly, Inc. vs. RJL Martinez Fishing Corp., 166 SCRA 473 [1988]; Filinvest Credit Corp. vs. Court of Appeals, 178 SCRA 188 [1989].) It is not the parties but the law that determines the juridical situation created by them through their contract and the rights and obligations arising therefrom. Thus, in the light of the circumstances and facts in the record:

(1) A *pacto de retro* sale may be construed as a simple loan or equitable mortgage under Article 1602 of the Civil Code. (Gloria Diaz vs. Court of Appeals, 84 SCRA 483 [1978]; Labasan vs. Lacuesta, *supra*; see Note 3 under Art. 1365.)

(2) A contract to sell real estate may be considered a contract for the redemption of mortgaged property. (Phil. National Bank vs. Court of Appeals, 94 SCRA 357 [1979].)

(3) Although in the contract, the words "lease," "lessee," and "lessor" are employed, that is no obstacle to holding that said contract

is really a sale on installments (see Arts. 1484, 1485.), if such was the evident intention of the parties in entering into the said contract. (Abella vs. Gonzaga, 56 Phil. 132 [1931].)

(4) Notwithstanding its denomination or designation as a "contract of lease," its provisions and the contemporaneous acts of the contracting parties may disclose that the intent of the parties is to make the lessor an independent contractor for a piece of work. (Kilosbayan, Inc. vs. Guingona, Jr., 232 SCRA 110 [1994].)

(5) The fact that the document in question is entitled "Exclusive Option to Purchase" is not controlling where the text thereby shows that it is a contract to sell. (Adelfa Properties, Inc. vs. Court of Appeals, 240 SCRA 565 [1995].)

ILLUSTRATIVE CASES:

1. *The stipulations in a document entitled "Barter" indicate an intention on the part of the signatories thereto not to convey ownership of their respective properties.*

*Facts:* The spouses A and B were owners of a residential lot. They executed an agreement entitled "Barter" whereby they agreed to "barter and exchange" with spouses C and D the lot with the latter's riceland.

Under the agreement, the parties shall enjoy the material possession of their respective properties. A and B shall reap the fruits of the riceland while C and D shall have the right to build their house on the lot, and in the event any of the children of E (daughter of A and B) shall choose to reside and build his own house on the lot, C and D shall be obliged to return the lot to such children and that neither party shall encumber, alienate or dispose of their respective properties without the consent of the other.

F, son of E, filed a complaint to recover the lot from C and D claiming he needed it for his own house. C and D contended that the agreement transferred to him the ownership of the lot.

*Issue:* Did the parties really enter into a contract of barter?

*Held:* No. Contracts are not what the parties may see fit to call them but what they really are as determined by the principles of law. Thus, in the instant case, the use of the term "barter" in describing the agreement is not controlling. The stipulations in said document are clear enough to indicate that there was no intention at all on the part of the signatories thereto to convey the ownership of their respective properties. *(Baluran vs. Navarro, 79 SCRA 309 [1977].)*

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2. *Words used by parties in a document entitled "Kasulatang Sanlaan" indicate a pacto de retro sale.*

*Facts:* The document executed by S and B is entitled *"Kasulatang Sanlaan."* In the document, S declares: *"aking inilipat, ipinagbili nang biling mabibiling muli"* to B the parcel of land in question. Immediately after its execution, B entered into the possession of the land, paid taxes thereon, and enjoyed its fruits.

*Issue:* Is the title of the document controlling as to the nature of the contract entered into?

*Held:* No. The words used by the parties are expressive of their intent that the property be sold with a right of repurchase. These words must be given their common and ordinary meaning. The title is not a decisive factor. Furthermore, the actuations of both parties show that the document cannot even be presumed an equitable mortgage within the purview of any of the cases mentioned in Article 1602 of the Civil Code. *(Magtira vs. Court of Appeals, 96 SCRA 680 [1980].)*

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3. *One employed as farm worker under a Labor Contract worked as a tenant.*

*Facts:* The contract executed by the parties is captioned "Labor Contract" providing, among others, that E shall be paid by R the sum of P8.00 per day of actual work done on the field. It appears, however, that: E did not receive any wage but rather a share in the net produce of the land; he paid a rental of 25% of the harvest; he got cash advances or "vales" only as his needs arose; he did not observe regular work hours; he handled all phases of farm work although at times with aid of hired labor; and he has hut erected on the landholding.

*Issue:* Is E a farm worker or a tenant?

*Held*: A tenant. The title of a contract does not necessarily determine its true nature. Judicial notice may be taken of the practice of landowners, by way of evading the provisions of tenancy laws, to have their tenants sign contracts or agreements intended to camouflage the real import of their relationship. *(Cruz vs. Court of Appeals, 129 SCRA 222 [1984].)*

**ART. 1372. However general the terms of a contract may be, they shall not be understood to comprehend things that are distinct and cases that are different from those upon which the parties intended to agree. (1283)**

**Special intent prevails over a general intent.**

As a rule, where in a contract there are general and special provisions covering the same subject matter are inconsistent, the latter shall be paramount to and control over the former when the two cannot stand together. (Hibberd vs. Estate of McElroy, 25 Phil. 164 [1913]; TSPIC Corporation vs. TSPIC Employees Union, 545 SCRA 215 [2008].)

The reason for this rule is that when the parties express themselves in reference to a particular matter, the attention is directed to that, and it must be assumed that it expresses their intent; whereas, a reference to some general matter, within which the particular matter may be included, does not necessarily indicate that the parties had that particular matter in mind. (12 Am. Jur. 779.)

EXAMPLES:

(1) S sold his house "including all the furniture therein." The term "all" should not be understood to include S's refrigerator which is distinct and different from "furniture."

Neither should it be interpreted to include chairs borrowed by S from C for the reason that they do not belong to S.

(2) S sold parcels of land to B. In the deed of sale, the description stated a greater extension than the actual area of the lands sold thereby including a piece of land belonging to C.

This piece of land cannot be among the subject matter of the sale simply because it was included in the description.

(3) R mortgaged his land to secure the debt of D to C, without expressly assuming personal liability for the debt. In case there is a deficiency remaining after the mortgage is foreclosed, R cannot be compelled to pay the same.

ILLUSTRATIVE CASES:

1. *"Fair value" mentioned in a contract of lease was not construed as referring to the purchase price because purchase by the lessee of the leased property was never intended by the parties.*

*Facts*: Under an agreement entitled "Contract of Lease," it is provided, among others, that the "lessee shall surrender possession of the premises upon the expiration of his lease and if so required by the lessor, shall return the premises in substantially the same condition as that existing at the time the same were first occupied by the lessee, . . . provided that the

lessee shall have the right and privilege to compensate the lessor at the fair value or equivalent, in lieu of performance of its obligation, if any, to restore the premises.

Fair value is to be determined as the value at the time of occupancy less wear and tear and depreciation during the period of this lease."

*Issue:* Does "fair value" at the time of occupancy mentioned in the lease agreement refer to the value of the property if bought by the lessee?

*Held:* No. It refers to the cost of restoring the property in the same condition as of the time when the lessee took possession of the property.

What was expressly agreed upon in the lease agreement was that, should the lessor require the lessee to return the premises in the same condition as at the time the same was first occupied by the lessee, the latter would have the "right and privilege" (option) of paying the lessor what it would fairly cost to put the premises, in the same condition as it was at the commencement of the lease in lieu of the lessee's performance of the undertaking to put the land in said condition. Such fair value cannot refer to the purchase price, for purchase was never intended by the parties. It is a rule in the interpretation of contracts that "However general . . . agree." *(Republic vs. Vda. de Castellvi, 58 SCRA 336 [1974].)*

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2. *The heirs intended to assume only those obligations of the decedent enumerated in an Inventory attached to their Partition Agreement but the Agreement refers "to all the obligations and liabilities" of the decedent.*

*Facts:* In the intestate proceedings of D (decedent) no claims were filed within the period fixed in the notice to creditors. Legally, therefore, creditors of D are forever barred from prosecuting any claim against the estate of D, pursuant to Section 5, Rule 86 of the Rules of Court. Nevertheless, H, etc., intestate heirs of D, aware that the latter did leave obligations and liabilities, the existence of which they acknowledged and enumerated in the Inventory of Estate Liabilities and/or Obligations attached to the Partition Agreement, personally assumed payment of the same in proportion to their shares in the estate of the decedent.

C, a creditor of D, filed a civil case against H, etc. on the latter's undertaking in the Partition Agreement to assume and pay all the outstanding liabilities and obligations of D. Admittedly, C's claim is not listed in the Inventory. C argues that inasmuch that paragraphs 5(c) and 7(c) of the Partition Agreement providing for the assumption by H, etc. of "all liabilities or obligations of the decedent," omitted any reference to the Inventory in paragraph 4 thereof, those paragraphs were meant to

include all other liabilities and obligations of the decedent although not listed in said Inventory.

*Issue:* Are H, etc. personally liable to C?

*Held:* No. H, etc. intended to assume only those obligations of D which they acknowledged and enumerated in the Inventory. Paragraphs 5(c) and 7(d) merely define the extent and proportion by which they assumed the decedent's obligations and should not be construed to comprehend all other obligations of the decedent.

The rule that "particularization followed by a general expression will ordinarily be restricted to the former" is based on the fact in human experience that usually the minds of the parties are addressed specially to the particularization, and that the generalities, though broad enough to comprehend other fields if they stood alone, are used in contemplation of that upon which the minds of the parties are centered. In other words, the enumeration in the Inventory of the liabilities or obligations of D, expressly acknowledged by H, etc. and the payment of which had been assumed by them implied the exclusion of all others.

Moreover, considering that H, etc. themselves had assumed the obligation of answering to creditors for the debts and obligations of D, it is but just that they should be bound only by the exact terms of their promise. *(Empire Insurance Co. vs. Rufino, 92 SCRA 437 [1979].)*

**ART. 1373. If some stipulation of any contract should admit of several meanings, it shall be understood as bearing that import which is most adequate to render it effectual. (1284)**

### Interpretation of stipulation with several meanings.

When an agreement is susceptible of several meanings, one of which would render it effectual, it should be given that interpretation. Thus, if one interpretation makes a contract valid or effective and the other makes it illegal or meaningless, the former interpretation is one which is warranted by the rule stated in Article 1373. (see Luna vs. Linato, 74 Phil. 15 [1942]; Phil. National Bank vs. Utility Assurance & Surety Co., Inc., 177 SCRA 208 [1989]; Lao Lim vs. Court of Appeals, 191 SCRA 150 [1990]; Gonzales vs. Heirs of Thomas and Paulo Cruz, 112 SCAD 546, 314 SCRA 585 [1999].)

**ART. 1374. The various stipulations of a contract shall be interpreted together, attributing to the doubtful ones that sense which may result from all of them taken jointly. (1285)**

**Interpretation of various stipulations/ separate writings of a contract.**

(1) *Conflicting provisions of contract.* — As in statutes, the provisions of a contract should not be read in isolation from the rest of the instrument but, on the contrary, interpreted in the light of other related provisions. It is a canon of statutory construction that "the whole and every part of the statute must be considered in fixing the meaning of any of its parts and in order to produce a harmonious whole." This is also the injunction in Article 1374. (De Leon vs. Court of Appeals, 205 SCRA 612 [1992].) The legal effect of the contract is not to be determined alone by any particular provision disconnected from all others. (Saludo, Jr. vs. Court of Appeals, 207 SCRA 498 [1992].)

A contract must be interpreted as a whole and the intention of the parties is to be gathered from the entire instrument and not from particular words, phrases, or clauses, having in mind the intention of the parties and the purpose to be achieved, consistent with their contemporaneous and subsequent acts (Art. 1371.) as regards the execution of the contract. All provisions should, if possible, be so interpreted as to harmonize with each other, and give effect to all, *e.g.*, all the words, not just a particular word or two, and words in context, not words standing alone. (China Banking Corporation vs. Court of Appeals, 265 SCRA 327 [1996]; see De Mesa vs. Court of Appeals, 317 SCRA 24 [1999]; Cruz vs. Court of Appeals, 456 SCRA 165 [2005]; Bangko Sentral ng Pilipinas vs. Santamaria, 395 SCRA 841 [2002]; The Insular Life Assurance Co., Ltd. vs. Court of Appeals, 428 SCRA 79 [2004]; Philippine Fisheries Dev. Authority vs. Court of Appeals, 467 SCRA 449 [2005]; Manila International Airport Authority vs. Ginagoyon, 476 SCRA 570 [2006]; Hanjin Heavy Industries & Construction Co. vs. Dynamic Planners & Construction Corp., 553 SCRA 541 [2008].) The ascertained intention of the parties is deemed an integral part of the contract as though it has been originally expressed in unequivocal terms. (Republic vs. David, 436 SCRA 577 [2004].)

(a) In a case where the mortgagor sold the foreclosed properties under a "Deed of Sale with Assumption of Mortgage," it was held that the contract's recognition of both the preferential right of the mortgagor to redeem the mortgage properties from the mortgage and the sale of the properties to the vendee was in order, as it would harmonize and give effect to all the provisions of the deed of sale. The grant by the mortgagee of the mortgagor's request

to repurchase the mortgaged properties redounded to the benefit of the vendee, the sale of the said properties having been previously agreed upon by the mortgagor-vendor and the vendee. The vendor can validly redeem subject properties and still recognize the sale thereof to the vendee because nothing therein is contrary to law, morals, good customs, public order, or public policy. (De Mesa vs. Court of Appeals, *supra*.)

(b) In a case involving a contract of lease, petitioners contend that they cannot be ejected from the subject premises because after 7 1/2 years they became lessees of the undivided one-half portion that became the property of private respondents. Hence, since there was an existing lease over the building they cannot be ejected by private respondents. On the other hand, private respondents say that the lease covers only the lot and not the building also and, therefore, as they had become co-owners of the building, they had the right over an undetermined half of the property.

In line with Article 1374, the phrase "on the lot and/or both lot and building" in the fourth paragraph of the agreement was interpreted as indicating that the lease covers both the land and the building. The duration of this agreement is 15 years as stated in the third paragraph. Hence, even if private respondents became co-owners of the building on March 1, 1994 after 7 1/2 years, petitioners' lease over the land and the building gave them the right to remain in the premises until the year 2001.

The monthly rental of P5,000.00 is for "the lot and/or both lot and building." Indeed, the parties to the agreement could have simply said "lot and building," but they did not. Instead, they said "lot and/or both lot and building," indicating thereby that during the first half (7 1/2 years) of the agreement the lease would cover only the lot since during that period petitioners were the absolute owners of the entire building. After that period, however, *i.e*., during the second half, the lease would cover both the lot and the building since the latter would by then be owned in common by private respondents and petitioners. (Lee vs. Court of Appeals, 345 SCRA 707 [2000].)

(2) *Contract contained in several documents.* — Where the contract is contained in several documents or in two or more separate writings all of them must be taken together to determine the intention of the

parties. (see Asia vs. Pardo, 2 Phil. 401 [1903]; Phil. Trust Co. vs. Echaus, 52 Phil. 852 [1928]; Bank of the Phil. Islands vs. Ty Camco Sobrino, 57 Phil. 801 [1933]; G. Litton vs. Phil. National Bank, 70 Phil. 108 [1940]; People's Bank & Trust Co. vs. Odom, 64 Phil. 126 [1937]; Ruiz vs. Sheriff of Manila, 34 SCRA 83 [1970]; Reparations Commission vs. Northern Lines, Inc., 34 SCRA 203 [1970]; Layug vs. Intermediate Appellate Court, 167 SCRA 627 [1988].)

Applying the *"complementary-contracts-construed-together"* doctrine, they should be read and interpreted together in such a way as to eliminate seeming inconsistencies and render the parties' intention effective. Certain stipulations cannot be segregated and then made to control. This *no segregation principle* is based on Article 1374. (Constantino vs. Desierto, 288 SCRA 654 [1998]; see Velasquez vs. Court of Appeals, 309 SCRA 539 [1999]; Golden Diamond, Inc. vs. Court of Appeals, 332 SCRA 605 [2000]; Rigor vs. Consolidated Orx Leasing and Finance Corporation, 387 SCRA 437 [2002]; Valdez vs. Court of Appeals, 439 SCRA 55 [2004]; Blas vs. Angeles-Hutalla, 439 SCRA 273 [2004]; Phil. Bank of Communication vs. Lim, 455 SCRA 714 [2005].) Thus, the provisions of an accessory contract (*e.g.*, suretyship, pledge, mortgage) must be read and construed in its entirety and together with the principal contract (loan agreement) between the parties. Construction of the terms of a contract, which would amount to impairment or loss of right is not favored. Conservation and preservation, not waiver, abandonment or forfeiture of a right is the rule. (Ridjo Tape & Chemical Corp. vs. Court of Appeals, 286 SCRA 544 [1998]; Agas vs. Sabico, 457 SCRA 263 [2005]; Constantino vs. Sandiganbayan, 533 SCRA 205 [2007].) Of course, the provisions in the principal contract are not always controlling, as where error or mistake is shown.

(3) *Business forms.* — Business forms, *e.g.,* order slip, delivery charge invoice and the like, which are issued by the seller in the ordinary course of business are not always fully accomplished to contain all the necessary information describing in detail the whole business transaction. In most cases the sales clerk merely indicates a description and the price of each item sold without bothering to fill up all the available spaces in the receipt or invoice. More often than not, they are accomplished perfunctorily without proper regard to any legal repercussion for such neglect. Despite their being often incomplete, said business forms are commonly recognized in ordinary commercial

transactions as valid between the parties and at the very least, they serve as an acknowledgment that a business transaction has in fact transpired. Oftentimes, these forms are issued by laymen who, not fully appreciating their legal signification, prepare them in a slipshod manner.

In the light of the foregoing, they are not to be given the same standard of construction as formal documents where the contents are more closely scrutinized and every provision strictly interpreted. (Donato C. Cruz Trading Corporation vs. Court of Appeals, 347 SCRA 13 [2000].)

(4) *Titles/separability clause in contract.* — Titles given to sections of a contract may be resorted to for the purpose of determining the scope of the provisions and their relation to other portions thereof. But two separate sections or articles of a contract cannot be correlated with each other where the parties have expressly provided for a separability clause, *i.e.,* that one article cannot have a restrictive effect upon the meaning of another article. (Singapore Airlines Local Employees Assoc. vs. National Labor Relations Commission, 129 SCRA 472 [1984].)

EXAMPLE:

R leased his house to E. In the contract, it was stated that E should not sublease the house without the written consent of R. Another stipulation therein contained stated that E should pay P1,000.00, as additional rent a month should he violate this condition. E subleased the house without the consent of R.

Has R the right to eject E? No, in the light of the clause stating the penalty for the violation of the condition. (see Bank of the Phil. Islands vs. Ty Camco Sobrino, 57 Phil. 801 [1933].)

ILLUSTRATIVE CASES:

1. *Stipulations and language employed in a "Bill of Assignment" of a formula indicate an intention to transfer only the "use" of the formula.*

*Facts:* P executed a Bill of Assignment in favor of UFC which recites, among others, that the patentee (P) "assigns, transfers and" conveys all his property rights and interest over said *Mafran* trademark and formula for *Mafran Sauce* unto UFC" and that "such assignment, transfer and conveyance is absolute and irrevocable and in no case shall P ask, demand or sue for the surrender of his rights and interest over said *Mafran* trademark and formula."

*Issue:* UFC claims that the formula itself was ceded to it. On the other hand, P contends that what was transferred was only the use of the formula.

*Held:* A literal reading of the Bill of Assignment seems to support the conclusion that the formula itself was ceded by the patentee. However, an analysis of the entire instrument and the language employed therein would lead one to the conclusion that the intention of the parties was to transfer only the *use* of the formula.

*Firstly,* one of the principal considerations of the assignment is the payment of "royalty of 2% of the net annual profit" which UFC may realize out of its production of Mafran sauce. The word "royalty," when employed in connection with a license under a patent, means the compensation paid for the use of a patented invention.

*Secondly,* to preserve the secrecy of the formula, it is provided that P was to be appointed "chief chemist . . . permanent in character, of UFC and that in case of his "death or other disabilities," then his "heirs or assigns who may have the necessary qualifications shall be preferred to succeed him;" and that P shall exercise absolute control and supervision over the laboratory and personnel and over the purchase and safekeeping of the chemicals and other mixtures used in the preparation of the said product.

*Thirdly,* should dissolution of UFC take place, "the property rights and interests over said trademark and formula shall automatically revert" to P.

*Fourthly,* the facts of the case compellingly demonstrate continued possession of the formula by P.

*Finally,* a conveyance should be interpreted to effect "the least transmission of rights." (Art. 1378, par. 1.), and allowing or permitting only the use, without transfer of ownership, of the formula, would effect "the least transmission of rights." *(Universal Food Corp. vs. Court of Appeals, 33 SCRA 1 [1970].)*

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2. *Main contract contains a 90-day warranty period against defects with surety bond while annex thereto provides a one-year warranty period against defects without mention of surety bond.*

*Facts:* Under a written contract, P undertook to do a painting job for C (Caltex [Phils.].) Among others, the contract provided that should any defect be found by C within 90 days from the acceptance of the work, P shall make good such defect. P furnished a surety bond given by S (surety) "for any defect arising out of defective materials or workmanship

which may be found by C within 90 days from date of completion and acceptance of work." The last clause of the "Specifications for Tank Painting," Annex "A," on the other hand, provides thus: "Any defects in workmanship that may be discovered within the period of one year shall be corrected by P without any additional charge to C."

The alleged defects in the painting job were noted only after more than three months. S filed a complaint against P to recover what it had paid to C under the bond, and on the strength of the indemnity agreement executed by P in favor of S.

*Issue:* Is S entitled to reimbursement from P for paying C on the surety bond, the alleged defects having been discovered after 90 days but within one (1) year from acceptance of the painting job?

*Held:* No. The 90-day warranty period in the main painting contract should be applied. Its evident purpose is to make the surety bond liable for defects discovered within the 90-day period defined. On the other hand, the 1-year warranty clause in the contracts Annex "A" not only fails to mention the surety bond but explicitly makes P directly and personally liable for the defects therein contemplated.

The two provisions may, therefore, be reasonably reconciled with each other and construed together to mean that P and C intended for the *surety bond* to be chargeable for "defects arising out of defective materials or workmanship" found within 90 days but for P to be directly liable for "defects in workmanship" discovered beyond said period of 90 days and until nine (9) more months thereafter, to complete the one-year period. Hence, C could no longer enforce the surety bond and as a necessary consequence, S should not have paid C on the bond and correspondingly, P may not be required to reimburse S under the indemnity agreement.

Parenthetically, had this been a suit between C and P, the latter would have been liable to correct such defects on the basis of the last clause of Annex "A." *(Phil. American General Insurance Co. vs. Court of Appeals, 114 SCRA 4 [1982].)*

**ART. 1375. Words which may have different significations shall be understood in that which is most in keeping with the nature and object of the contract. (1286)**

## Interpretation of words with different significations.

If a word is susceptible of two or more meanings, it is to be understood in that sense which is most in keeping with the nature and object

of the contract in line with the cardinal rule that the intention of the parties must prevail. (Art. 1370.)

EXAMPLE:

R leased to E a roof for the purpose of erecting an advertising sign. The contract provides for the termination of the lease by E if a "building" should be constructed on an adjoining property of such height as to obscure the view of E's sign. There was erected on the roof of an adjoining building a sign which obstructed the view of E's sign.

In this case, the term "building" as the term is used in the contract may be interpreted to include the obstructing sign having in mind the nature and object of the contract.

ILLUSTRATIVE CASES:

1. *Scope of authority of agent to "exact the payment" of the sums of money "by legal means."*

*Facts:* A (agent) was appointed by P (principal) as manager of the latter's business under a power of attorney which confers authority to "exact the payment" of sums of money "by legal means."

*Issues:* Does this authority include the power to exact the payment of debts due the business concern by the institution of suits for their recovery?

*Held:* Yes, for it cannot be reasonably supposed, in the absence of very clear language to that effect, that it was the intention of P to withhold from A a power so essential to the efficient management of the business entrusted to his control as that of suing for the collection of debts. *(German & Co. vs. Donaldson, Sim & Co., 1 Phil. 63 [1905].)*

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2. *In one deed, the bank may be compelled to pay; in another deed, it is given the option of whether or not to pay certain obligations.*

*Facts:* SIP corporation purchased three vessels thru financing furnished by defendant bank, BPI. The vessels were placed under the booking agency of defendant ISC with the undertaking that freight revenues shall be deposited with the BPI. As SIP and BPI were not satisfied with the amount of revenues being deposited, SAG was organized to manage the operations of the vessels without, however, terminating the booking agency of ISC. SAG contracted the services of P to carry out repairs in said vessels.

Payment for the cost of repairs was advanced by ISC which,

however, stopped payment of the checks for the balance. Consequently, BPI (drawee) dishonored the checks when presented for payment by P.

Meanwhile, by reason of the inability of SIP to pay its mortgage indebtedness, it sold the vessels to mortgagee BPI by way of *dacion en pago.* Immediately preceding the execution of the deed of sale, SIP and BPI executed a "Confirmation of Obligation" whereby the parties acknowledged, among others, the obligation due to P. The "confirmation" provides that SIP has "authorized BPI to pay certain expenses in connection with the sold vessels."

P instituted action against SIP, ISC, SAG, and BPI to recover the balance.

*Issue:* Did BPI in purchasing the vessels assumed the obligations SIP on the basis of the confirmation of obligation?

*Held:* Yes. At the time the subject obligation was incurred, the vessels were owned by SIP although mortgaged to BPI. Hence, SIP as owner is liable for the cost of repairs. ISC and SAG were undeniably mere agents of SIP, the disclosed principal. BPI, being the purchaser of the vessels, is jointly and severally liable for the balance of the repairs admittedly a lien in the vessels.

The "Confirmation of Sale" is but a part of or a corollary to the deed of sale. In fact, reference thereto was made by the deed of sale as to the settlement of obligations, among which are the repairs in question. Said deed provides: "any amount or amounts that the Bank has voluntarily paid and/or has been compelled to pay or hereafter will voluntarily and/or will be compelled to pay for the encumbrance, claim or particular average x x x in order to save the vessel from any legal seizure or suits by third parties shall be for the account of SIP x x x."

Applying Articles 1370, 1371, 1373, and 1374, the above stipulation interpreted together with the "Confirmation of Obligation" leaves no room for doubt that while the bank may indeed pay certain obligations voluntarily or by choice, there are those that the bank will be compelled to pay to save the vessels from any legal seizure or suits by third parties. In other words, the primary purpose of the contracts is the protection of the vessels. Among them are liens on the same under which the obligation to P belongs. *(Bank of the Phil. Islands vs. Pineda, 156 SCRA 404 [1987].)*

**ART. 1376. The usage or custom of the place shall be borne in mind in the interpretation of the ambiguities of a contract, and shall fill the omission of stipulations which are ordinarily established. (1287)**

**Resort to usage or custom as aid in interpretation.**

The usage or custom of the place where the contract was entered into may be received to explain what is doubtful or ambiguous in a contract on the theory that the parties entered into their contract with reference to such usage or custom.

Courts take no judicial notice of custom. It is, therefore, necessary to prove the existence of usage or custom like any other fact according to the rules of evidence (see Art. 12.), the burden of proof being upon the party alleging it. But usage or custom is not admissible to supersede or vary the plain terms of a contract. That which is agreed upon in a contract is the law between the contracting parties (Art. 1159.) provided it is not contrary to law, morals, good customs, public order, or public policy. (Art. 1306.)

EXAMPLES:

(1) X rendered services to Y but the contract did not provide for the amount of compensation to be paid.

In this case, the amount must be determined by the rate customarily paid in the place where the services were rendered. (see Arroyo vs. Azur, 76 Phil. 493 [1946].)

(2) In a contract, the word "prenda" is used. This word admits of several definitions, as its usage in particular parts of the country dictates.

It is a kind of special contract which is akin to *salda* in Ilocano, *sangra* in Bicol, or *mortgage in prenda* whereby the debtor delivers to the creditor the possession of a parcel of land as security for a loan he has obtained from the latter who enjoys the usufruct. It may be equated with the ordinary mortgage. It may be construed also as a sale with a right of repurchase. (Republic vs. Intermediate Appellate Court, 234 SCRA 285 [1993].)

**Allegation and proof of customs and usages.**

(1) *Where custom or usage general in character.* — If a custom or usage be general in character, and, therefore, presumed to be known by the parties, the rule is that such custom or usage may be proved without being specifically pleaded. This is particularly true when a general custom is offered in evidence to throw light upon a contract,

the terms of which are obscure, and which is dependent upon evidence of such general custom to make it plain.

(2) *Where custom or usage local in character.* — If the custom or usage be local in character, the party who proposes to rely upon it should aver it in his pleadings, and a local custom or usage applying to a special or particular kind of business (like the custom of "discounting notes") may not be proved to explain even the ambiguous terms of a contract, unless the existence of such custom or usage is pleaded. (Andreas vs. Bank of the Phil. Islands, 47 Phil. 795 [1925], citing 27 R.C.L. 195.)

**ART. 1377. The interpretation of obscure words or stipulations in a contract shall not favor the party who caused the obscurity. (1288)**

### Interpretation of obscure words.

A written agreement should, in case of doubt or ambiguity, be taken *contra proferentum, i.e.,* be interpreted strictly against the party who has drawn it, or be given an interpretation which will be favorable to the other who, upon the faith of which, has incurred an obligation (12 Am. Jur. 795-796; see Hijos de la Rama vs. Betia, 54 Phil. 149 [1929]; Reyes vs. De la Cruz, 105 Phil. 372 [1959]; Coscolluela vs. Valderama, 2 SCRA 1095 [1961]; Commissioner of Internal Revenue vs. Cadwallader Pacific Co., 73 SCRA 59 [1976].), when justified in light of the operative facts and surrounding circumstances. (Nacu vs. Court of Appeals, 231 SCRA 237 [1994]; ADR Shipping Services, Inc. vs. Gallardo, 389 SCRA 82 [2002].) Thus, one who prepared the contract which states: "Terms: Cash upon signing of this contract," cannot deny that the agreement was a cash transaction. (Lim Yhi Luya vs. Court of Appeals, 99 SCRA 668 [1980].)

The reason for the rule in Article 1377 is that the party who drafted the contract, more easily than the other, could have prevented mistakes or ambiguity in meaning by careful choice of words or by the exercise of a little more care; and generally, the party who causes the obscurity acts with ulterior motives.

Article 1377 is not applicable where the evident intention of the parties can be readily discerned by their contemporaneous and subsequent acts (Art. 1371.) and there is no indication that the party who prepared the contract took unfair advantage of the other party

who freely assented to it which is written entirely in a language spoken and understood by both parties. (Almira vs. Court of Appeals, 399 SCRA 351 [2003].)

**Contracts of adhesion.**

These contracts are so-called because almost all their provisions have been drafted by one party, and the only participation of the other party is the signing of his signature or his "adhesion" thereto on the "take it or leave it" basis, without the right to modify it.

(1) *Contracts of insurance.* — The rule in Article 1377 is generally applied to contracts of insurance which are liberally construed in favor of the insured and strictly and most strongly against the insurer, resolving all ambiguities against the latter.

This principle of interpreting insurance policies when the terms thereof are ambiguous, equivocal, or uncertain can better be understood when it is remembered that a policy of insurance is a contract of "adhesion," that is to say, most of the terms of the contract do not result from mutual negotiation between the parties as they are prescribed in printed forms, to which the insured may "adhere" if he chooses but which he cannot change. (Del Rosario vs. Equitable Insurance & Casualty Co., 8 SCRA 343 [1963]; see Union Manufacturing Co. vs. Phil. Guaranty Co., Inc., 47 SCRA 271 [1972]; Landicho vs. GSIS, 44 SCRA 7 [1972]; Rizal Surety & Insurance Company vs. Court of Appeals, 336 SCRA 12 [2000].)

The insured usually has no voice in the selection or arrangement of the words employed, and the language of the contract is selected with great care and deliberation by experts and legal advisers employed by, and acting exclusively in the interest of the insurance company. (44 C.J.S. 1174.) This is especially true where the stipulations are printed in fine letters and are hardly legible. (Geraldez vs. Court of Appeals, 230 SCRA 320 [1994].)

(2) *Contracts in bills of lading.* — The above rules are applicable to contracts contained in bills of lading (H.E. Heacock vs. Macondray, 42 Phil. 205 [1921]; see Fieldmen's Insurance Co., Inc. vs. Vda. de Songco, 25 SCRA 70 [1968]; Sweet Lines, Inc. vs. Teves, 83 SCRA 361 [1978]; Eastern Shipping Lines, Inc. vs. Margarine-Verkaups-Union, 93 SCRA 257 [1979].), such as plane tickets (Ong Yiu vs. Court of Appeals, *supra.*), the provisions of which have been held to be a part of the contract of carriage and valid and binding upon the passenger although he had

not signed the plane ticket and regardless of his lack of knowledge or assent to the conditions (Pan American World Airways, Inc. vs. Intermediate Appellate Court, 164 SCRA 268 [1988].)

A bill of lading for goods operates both as a receipt for the goods shipped or transported and as a contract to transport and deliver the same as therein stipulated.

The reasons behind stipulations in plane tickets on liability limitations arise from the difficulty if not impossibility of establishing with a clear preponderance of evidence the contents of a lost baggage. Unless the contents are declared, it will always be the word of a passenger against that of the airline. (Pan American World Airways, Inc. vs. Rapadas, 209 SCRA 64 [1992].)

(3) *Contracts between a lawyer and his client.* — The rule also applies to a contract of professional services between a lawyer and his client, and rightly so because of the inequality of the situation between an attorney who knows the technicalities of the law on the one hand, and a client who usually is ignorant of the vagaries of the law, on the other hand. (Fabello vs. Intermediate Appellate Court, 195 SCRA 28 [1991].)

(4) *Other contracts.* — The rule likewise applies to all other contracts where their provisions have been drafted only by one party, usually a corporation.

(a) Thus, a deed *of chattel mortgage* was held a contract of adhesion because it was done solely by petitioner corporation and the only participation of the other party was the affixing of his signature or his "adhesion" thereto. (BPI Credit Corporation vs. Court of Appeals, 204 SCRA 601 [1991].)

(b) There is no way a prospective credit card holder can object to any onerous provision in a contract containing standard stipulations prepared by a credit card company imposed upon those who seek to avail of its credit services as it is offered on a take-it-or-leave-it basis. (BPI Express Card Corporation vs. Olalia, 372 SCRA 338 [2001].) A stipulation in a credit card that the "x x x cardholder responsibility for all charges made through the use of his card shall continue until the expiration or its return to the card issuer or until a reasonable-time after receipt by the Card Issuer a written notice of loss of the card and its actual inclusion in the Cancellation Bulletin x x x" is repugnant to public policy since the effectivity of the cancellation of the lost card rests on an act entirely

beyond the control of the holder. (Acol vs. Phil. Commercial Credit Card, Inc., 496 SCRA 422 [2006].) It is incorrect to give a credit card company blanket freedom from liability if its card is dishonored by an merchant affiliate for any reason. A stipulation in a credit card agreement which limits the card company's liability to P1,000 or the actual damage proven, whichever is lesser, cannot be considered as valid for being unconscionable as it precludes payment of a larger amount even though damage may be clearly proven. (Aznar vs. Citibank, N.A. [Phils.], 519 SCRA 287 [2007].)

(c) The rule also applies to contracts of employment. (see Phil. Federation of Credit Cooperatives, Inc. vs. National Labor Relations Commission, 300 SCRA 72 [1998].) Employment agreements are usually contracts of adhesion. (Magellan Capital Management Corporation vs. Zosa, 355 SCRA 157 [2001].) With respect to *labor contracts,* the Civil Code provides that in case of doubt, they "shall be construed in favor of the safety and decent living for the laborers." (Art. 1702 thereof.) The Constitution likewise mandates a liberal interpretation of labor contracts in favor of the working class conformably to the social justice policy to afford full protection to labor. (Art. XIII, Sec. 3 thereof.) Labor contracts are impressed with public interest. (OSM Shipping Phil., Inc. vs. De La Cruz, 449 SCRA 525 [2005].)

(5) *Validity*. — Contracts of adhesion wherein one party, usually a corporation, imposes a ready made form of contract on the other who, if he accepts, merely affixes his signature or his "adhesion" thereto, giving no room for negotiation and depriving the latter of the opportunity to bargain on equal footing, are not entirely prohibited. These types of contracts are as binding as ordinary contracts (see Art. 1306.), the reason being the one who adheres to the contract is in reality free to reject it entirely; if he adheres, he gives his consent (Ong Yiu vs. Court of Appeals, 91 SCRA 223 [1979]; Serra vs. Court of Appeals, 229 SCRA 66 [1994]; Telengtan Brothers & Sons, Inc. vs. Court of Appeals, 236 SCRA 617 [1994]; Titan Construction Corp. vs. Uni-Field Enterprises, Inc., 517 SCRA 180 [2007].) but cannot modify. It is presumed that a person takes ordinary care of his concerns — one does not sign a document without first informing himself of its contents and consequences. (Lee vs. Court of Appeals, 375 SCRA 572 [2002]; Poltan vs. Family Savings Bank, Inc., 517 SCRA 430 [2007]; Panlilio vs. Citibank, N.A., 539 SCRA 69 [2007].)

(a) While such contracts are not entirely prohibited or strictly against the law, neither is blind reliance on them encouraged. In the face of facts and circumstances showing they should be ignored because of their basically one-sided nature, the courts are justified to rule out blind adherence to their terms (Pan American World Airways, Inc. vs. Teves, *supra;* Polotan, Sr. vs. Court of Appeals, 296 SCRA 247 [1998]; Republic vs. David, 436 SCRA 577 [2004]; Gulf Resorts, Inc. vs. Phil. Charter Insurance Corp., 458 SCRA 550 [2005].) to shield the unwary from deceptive schemes contained in ready-made covenants. (Ayala Corporation vs. Ray Burton Development Corp., 294 SCRA 48 [1998]; see Ermitaño vs. Court of Appeals, 306 SCRA 218 [1999]; Cebu Shipyard & Engineering Works vs. William Lines, Inc., 306 SCRA 762 [1999].)

(b) While a contract of adhesion must be construed strictly, albeit not unreasonably, against the party who drafted the same or gave rise to any ambiguity therein, it may be struck down as void and unenforceable for being subversive of public policy only when the weaker party is imposed upon in dealing with the dominant bargaining party and is reduced to the alternative of taking it or leaving it, completely deprived of the opportunity to bargain on equal footing. (Saludo, Jr. vs. Court of Appeals, 207 SCRA 498 [1992]; National Development Co. vs. Madrigal, 412 SCRA 375 [2003]; Development Bank of the Phils. vs. Perez, 442 SCRA 238 [2004].) Thus, release forms, being in the nature of contracts of adhesion, are construed strictly against hospitals. A blanket release in favor of hospitals "from any and all claims," which claims are due to bad faith or gross negligence would be contrary to public policy. Even simple negligence is not subject to blanket release in favor of establishments like hospitals but may only mitigate liability depending on the circumstances. (Nogales vs. Capitol Medical Center, 511 SCRA 204 [2006].)

(c) The stringent treatment towards contracts of adhesion is in pursuance of the mandate in Article 24 of the Civil Code that "(i)n all contractual, property or other relations, when one of the parties is at a disadvantage on account of his moral dependence, ignorance, indigence, mental weakness, tender age or other handicap, the courts must be vigilant for his protection." (Ayala Corporation vs. Ray Burton Development Corp., *supra.*) It is, however, applicable only if the stipulations in such contracts

are obscure and unambiguous. If the terms thereof are clear and leave no doubt about the intentions of the contracting parties, there would be no need for construction. (Litonjua vs. L & R Corporation, 328 SCRA 796 [2000].) Thus, in a case, the provision on automatic suspension without notice embodied in the Credit Card Agreement was upheld, being couched in clear and unambiguous term, aside from the fact that the agreement itself was entered into by the respondent (credit card holder) who, by his own account, "is a reputable businessman engaged in business activities here and abroad." (Equitable Banking Corporation vs. Calderon, 446 SCRA 771 [2004].)

ILLUSTRATIVE CASE:

*The ambiguity is in the application for insurance.*

*Facts:* A provision in the application for insurance with the GSIS states this condition: "That any policy shall be made effective on the first day of the month next following the month the first premium is paid x x x." Another provision states: "That failure to deduct from my salary the monthly premiums *shall not make that policy lapse,"* and that, "*the premium account shall be considered as indebtedness* which I bind myself to pay the System."

E, an employee of the Bureau of Public Works died in an airplane crash. It appears, however, that the Bureau had not remitted to GSIS even a single premium.

*Issue:* Has the insurance taken effect?

*Held:* Yes. The ambiguity created by the operation of the conditions stated in the application should be interpreted adversely against the GSIS. *(Landicho vs. GSIS, 44 SCRA 7 [1972].)*

**ART. 1378. When it is absolutely impossible to settle doubts by the rules established in the preceding articles, and the doubts refer to incidental circumstances of a gratuitous contract, the least transmission of rights and interest shall prevail. If the contract is onerous, the doubt shall be settled in favor of the greatest reciprocity of interests.**

**If the doubts are cast upon the principal object of the contract in such a way that it cannot be known what may have been the intention or will of the parties, the contract shall be null and void. (1289)**

**Rules in case doubts are impossible to settle.**

When, despite the application of the preceding rules (Arts. 1370-1377.), certain doubts still exist, such doubts shall be resolved in accordance with the supplementary rules stated in the present article.

(1) *Gratuitous contract.* — If the doubts refer to incidental circumstances of a gratuitous contract (see Art. 1350.), such interpretation should be made which would result in the least transmission of rights and interests.

EXAMPLE:

R gave his car to E. It is not clear, whether the contract is a donation or a commodatum.

The contract should be presumed as a mere commodatum because it would transmit lesser rights than a donation since R retains his ownership of the car.

(2) *Onerous contract.* — If the contract in question is onerous (see Art. 1350.), the doubts should be resolved in favor of the greatest reciprocity of interests. (see Rodriguez vs. Belgica, 1 SCRA 611 [1961].)

EXAMPLE:

D borrowed from C P5,000.00 at 18% interest. It cannot be determined from the terms of the contract whether the loan is payable in six (6) months or in one (1) year.

It must be assumed that the period agreed upon is one (1) year which results in a greater reciprocity of interest since D can use the money for one (1) year, and C, on the other hand, can earn interest due for one (1) year instead of only six (6) months.

It has been held that in case of doubt as to whether a transaction is a pledge (see Arts. 2085, 2093.) or dation in payment (Art. 1245.), the presumption is in favor of pledge, the latter being a lesser transmission of rights and interests. (Lopez vs. Court of Appeals, 114 SCRA 671 [1982]; Manila Banking Corp. vs. Teodoro, Jr., 169 SCRA 95 [1989].) Similarly, a contract of lease should be presumed instead of a contract of sale. Here, the doubt refers as to which of two (2) contracts was entered into by the parties.

(3) *Principal object of contract.* — If the doubt refers to the principal object of the contract and such doubt cannot be resolved, thereby leaving the intention of the parties unknown, the contract shall be null and void.

EXAMPLE:

S sold his land to B. S has many lands. It cannot be determined which land was intended by the parties to be the subject of the sale.

Therefore, the contract shall be null and void and it is as if the parties have not entered into any contract at all.

ILLUSTRATIVE CASE:

*The properties covered by the deed of exchange were not specified and described.*

*Facts:* A deed of exchange was executed between X and Y, whereby X transferred all her rights in the estate of her deceased mother located at Iloilo to Y who, in turn, by way of exchange, conveyed all her rights to certain real and personal properties situated at Cotabato. X inherited actually nothing from her parents. Her share was adjudicated to her sister when the case for rescission filed by Y was already pending.

It is provided in paragraph 7 that the deed of exchange should not be construed as an acknowledgment by X and Y that they are entitled to the properties involved therein and that it was executed "in anticipation of a declaration" of their rights to the properties. Then, it is stipulated in paragraph 8 that the parties should take possession and make use of the properties involved in the deed. The properties covered by the deed were not specified and described.

While the deed gives the impression that it involves many properties, in reality it refers only to 8,124 square meters of land which Y would inherit from her uncle and to the 9,000 square meters representing the share of X in her parents' estate. However, X rendered impossible the performance of her obligation under the deed when she waived her share in favor of her sister.

*Issue:* Is the exchange valid?

*Held:* No. The two provisions mentioned are irreconcilable because the first contemplates that the properties are still to be awarded or adjudicated to the parties whereas the second envisages a situation where the parties have already control and possession thereof. It is evident from the deed that the intention of the parties relative to the lots, which

are the objects of the exchange, cannot be definitely ascertained. This circumstance renders the exchange void or "inexistent." (Art. 1409[6].)

The rescissory action of X may be treated as an action to declare void the deed of exchange. *(Marin vs. Adil, 130 SCRA 406 [1984].)*

**Rule where doubt involves a contract of sale.**

(1) *Greatest reciprocity of interests.* — If there is doubt for example, in a contract of sale, which is essentially onerous, the same shall be settled in favor of the greatest reciprocity of interests. Thus, whether the parties intended a suspensive condition or a suspensive period for the payment of the agreed price, the doubt shall be resolved in favor of the latter, that is, the buyer's obligation is deemed to be actually subsisting, with only its maturity postponed or deferred. (Gaite vs. Fonacier, 2 SCRA 830 [1961].)

In a case, the stipulation on interest in a deed of conditional sale provides that the vendee shall pay the balance of the purchase price on or before December 31, 1982 without incurring any liability for any interest and penalty charges. Should the balance remain unpaid, the vendee was given the right to pay the said balance during the grace period of six (6) months from January 1, 1993 to June 30, 1993, provided, that "interest at the rate of 12% *per annum* shall be charged and 1% penalty charge shall be imposed on the remaining diminishing balance."

The question is whether during the grace period, 12% interest *per annum* plus 1% penalty charge a month was payable "on the remaining diminishing balance" or whether during said period only 12% interest was payable while the 1% per month penalty charge would in addition begin to accrue on any balance remaining unpaid as of July 1, 1983.

It was held that the second interpretation is supported by the principle contained in Article 1378 that in case of ambiguity in contract language, that interpretation which establishes a less onerous transmission of rights or lesser burdens as to permit greater reciprocity between the parties, is to be adopted. (Castelo vs. Court of Appeals, 244 SCRA 180 [1995].)

(2) *Least transmission of rights.* — If the doubt is whether the transaction is one of sale or another contract, the one entered into should be deemed that which would effect "the least transmission of

rights." Thus, as between a sale (see Universal Food Corp. vs. Court of Appeals, *supra,* under Art. 1374.) with the right to repurchase *(pacto de retro)* and one of loan with mortgage, it must be assumed that the contract is one of loan, "because such a con-tract involves a smaller transmission of rights and interests, and the debtor does not surrender all rights to his property but simply confers upon the creditor the right to collect what is owing from the value of the thing given as security." (Olino vs. Medina, 13 Phil. 379 [1929]; Padilla vs. Linsangan, 19 Phil. 65 [1911]; Perez vs. Cortes, 15 Phil. 211 [1910].)

(3) *An equitable mortgage.* — In view of "the countless injustices, oppressive transactions, and violations of law which have been committed in connection with the contract of sale with *pacto de retro*." (Report of the Code Commission, p. 63.) Article 1603 expressly provides that "in case of doubt, a contract purporting to be a sale with a right to repurchase shall be construed as an equitable mortgage."

The law favors the least transmission of rights and interests over a property in controversy. The purpose of the law is to prevent circumvention of the law on usury and the prohibition against a creditor appropriating the mortgaged property. Additionally, it is aimed to end unjust or oppressive transactions in connection with sale of property. There are many cases of unlettered persons or even those with average intelligence who invariably find themselves in no position whatsoever to bargain fairly with their creditors. (Lopez vs. Sarabia, 439 SCRA 35 [2004].)

**ART. 1379. The principles of interpretation stated in Rule 123 of the Rules of Court shall likewise be observed in the construction of contracts. (n)**

### Principles of interpretation in the Rules of Court applicable.

The rules in the Rules of Court on the interpretation of documents are now contained in Rule 130, Sections 10 to 19. The rules may be summarized as follows:

(1) The language of a writing shall have the legal meaning it bears in the place of execution, unless the parties intended otherwise. (Sec. 10; see Art. 1370.)

(2) An instrument with several provisions or particulars shall be construed so as to give effect to all. (Sec. 11; see Art. 1373.)

(3) In case of conflict between a general and a particular provision, the latter shall prevail; so a particular intent will control a general one that is inconsistent with it. (Sec. 12; see Arts. 1370, 1372.)

(4) The circumstances under which the instrument was made, including the situation of the subject thereof and of the parties to it, may be considered in its interpretation. (Sec. 13; see Art. 1371.)

(5) Terms are presumed to have been used in their ordinary and generally accepted meaning unless intended to have been used in a different sense. (Sec. 14; see Art. 1375.)

(6) In case of conflict, the written words prevail over the printed form. (Sec. 15.)

(7) Experts and interpreters may be asked to declare the characters or the meaning of the language when such characters are difficult to decipher or the language is not understood by the court. (Sec. 16.)

(8) Of two constructions, that sense is to prevail against the party in which he understood it or which is most favorable to the party in whose favor the provision was made. (Sec. 17; see Art. 1377.)

(9) Of two constructions, one in favor and the other against natural right, the former is to be adopted. (Sec. 18.)

(10) Usage may be the basis to determine the true character of an instrument. (Sec. 19; see Art. 1376.)

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# INTRODUCTION

## To Chapters 6, 7, 8 and 9

There are four kinds of defective contracts. They are in the order of their defectiveness or efficaciousness:

(1) *Rescissible contracts.* — They are the least infirm or defective. They are valid because all the essential requisites of a contract exist but by reason of injury or damage to one of the parties or to third persons, such as creditors, the contract may be rescinded. Thus, the defect is external. Until such contracts are rescinded in an appropriate proceeding, they remain valid and binding upon the parties thereto (Chap. 6.);

(2) *Voidable contracts*. — They are also valid until annulled unless there has been a ratification. In a voidable contract, the defect is caused by vice of consent (Chap. 7.);

(3) *Unenforceable contracts.* — They cannot be sued upon or enforced unless they are ratified. As regards the degree of defectiveness, voidable contracts are further away from absolute nullity than unenforceable contracts. In other words, an unenforceable contract occupies an intermediate ground between a voidable and a void contract (Chap. 8.); and

(4) *Void or inexistent contracts*. — They are absolutely null and void. They have no legal effect at all and cannot be ratified. (Chap. 9.)

According to the Code Commission which prepared the draft of the present Civil Code, a great deal of confusion has been created by the faulty terminology used in the old Civil Code as regards defective contracts. There was no sufficient clarity as to *contratos nulos* and *contratos anulables* — void and voidable contracts. In order to put an end to the uncertainty and other ambiguities in the old Code, the present Code in a clear-cut and unequivocal way classifies and defines the various kinds of defective contracts, and states their consequences.

The Code Commission believed that with the explicit provisions upon the subject of defective contracts, the nebulous state of the law existing under the old Code would be dispelled. It is neither wise nor just, according to the Commission, that parties should be left in doubt as to the degree of effectiveness of their contractual relations. The legal profession is also entitled to know in a positive and unequivocal manner what contracts are rescissible, voidable, unenforceable, and void. (see Report of the Code Commission, pp. 138-140.)

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# Chapter 6

# RESCISSIBLE CONTRACTS

**ART. 1380. Contracts validly agreed upon may be rescinded in the cases established by law. (1290)**

### Meaning of rescissible contracts.

*Rescissible contracts* are those validly agreed upon because all the essential elements exist and, therefore, legally effective, but in the cases established by law, the remedy of rescission is granted in the interest of equity.

### Binding force of rescissible contracts.

They are valid and enforceable although subject to rescission by the court when there is damage or prejudice to one of the parties or to a third person. In a rescissible contract, there is no defect at all but by reason of some external facts, its enforcement would cause injustice.[1]

### Meaning of rescission.

*Rescission* is an equitable remedy granted by law to the contracting parties and sometimes even to third persons in order to secure reparation of damages caused them by a valid contract,[2] by means of the restoration of things to their condition prior to the celebration of said contract. (see 8 Manresa 748-749.)

This remedy should be distinguished from rescission under Article 119 in case of breach of obligation *(infra.),* or rescission of a contract by

[1]A rescissible contract is valid until rescinded. It is defective only in the sense that it causes economic prejudice or damage to one of the parties or to a third person.

[2]"Or to protect some incompatible and preferential right created by the contract." (Aquino vs. Tañedo, 39 Phil. 517 [1919]; Air France vs. Court of Appeals, 245 SCRA 485 [1995].)

mutual consent of the parties *(infra.)* which shall be governed by their agreement or other legal provisions but not by Chapter 6.

**Requisites of rescission.**

The following are the requisites in order that the remedy of rescission under this Chapter may be availed of:

(1) The contract must be validly agreed upon (Art. 1380; see Onglengco vs. Ozaeta and Hernandez, 70 Phil. 43 [1940].);

(2) There must be lesion or pecuniary prejudice or damage to one of the parties or to a third person (Art. 1381.);

(3) The rescission must be based upon a case especially provided by law (Arts. 1380, 1381, 1382.);

(4) There must be no other legal remedy to obtain reparation for the damage (Art. 1383.);

(5) The party asking for rescission must be able to return what he is obliged to restore by reason of the contract (Art. 1385, par. 1.);

(6) The object of the contract must not legally be in the possession of third persons who did not act in bad faith (*Ibid.,* par. 2.); and

(7) The period for filing the action for rescission must not have prescribed. (Art. 1389.)

It has been held that a contract for the sale of personal property expressly providing that the owner may rescind it if the purchaser fails to make the payments stipulated therein is not governed by Articles 1380, *et seq.,* but rather by Articles 1191 and 1600[3] of the Civil Code. (Guevarra vs. Pascua, 12 Phil. 311 [1908]; see, however, Art. 1381[5].)

**ART. 1381. The following contracts are rescissible:**

**(1) Those which are entered into by guardians whenever the wards whom they represent suffer lesion by more than one-fourth of the value of the things which are the object thereof;**

**(2) Those agreed upon in representation of absentees, if the latter suffer the lesion stated in the preceding number;**

**(3) Those undertaken in fraud of creditors when the latter cannot in any other manner collect the claims due them;**

[3]Art. 1600. Sales are extinguished by the same causes as all other obligations, by those stated in the preceding articles of this Title, and by conventional or legal redemption. (1506)

**(4) Those which refer to things under litigation if they have been entered into by the defendant without the knowledge and approval of the litigants or of competent judicial authority;**

**(5) All other contracts specially declared by law to be subject to rescission. (1291a)**

## Cases of rescissible contracts.

The subsidiary action for rescission (Art. 1383.) is limited to the rescissible contracts under Article 1381.

(1) *Contracts entered into in behalf of wards.* — A ward is a person under guardianship by reason of some incapacity. (see Art. 1329.) As a rule, the powers of the guardian with respect to the property of the ward are limited to mere acts of administration. Contracts involving real property must be approved by the court (see Arts. 320, 326; Rules of Court, Rules 95, 96.); otherwise, they are unenforceable. (see Art. 1403[1].)

EXAMPLE:

G is the guardian of W (ward). G sells the property of W worth P20,000.00 for only P15,000.00.

The contract of sale cannot be rescinded because the lesion[4] is not more than one-fourth. However, if the property is sold for less than P15,000.00, W can rescind the sale by proper action in court upon reaching the age of majority.

(2) *Contracts agreed upon in representation of absentees.* — An *absentee* is a person who disappears from his domicile, his whereabouts being unknown, and without leaving an agent to administer his property. A court may appoint a person to represent him specifying his powers and obligations in accordance with the rules concerning guardians. (see Arts. 381-382.) Likewise, the absentee must suffer lesion by more than one-fourth of the value of the property object of the contract to entitle him to the remedy of rescission.

It must be noted that paragraphs 1 and 2 refer only to transactions by guardians and absentees' representatives. Rescission cannot take place if the contracts have been approved by the court. As a general

[4]As to meaning of lesion, see Article 1355.

rule, lesion does not invalidate a contract except only in special cases specified by law. (see Art. 1355.)

(3) *Contracts undertaken in fraud of creditors.* — The action to rescind in fraud of creditors is known as *accion pauliana.* Here, as in No. (4), the remedy of rescission may be availed of by a third person. Such contracts are usually made without the knowledge of the creditors. In order that fraud of creditors may be a valid ground for rescission, the following requisites must *also* be present:

(a) There must be an existing credit prior to the contract to be rescinded, although it is not yet due or demandable later;

(b) The subsequent contract made by the debtor conveys a patrimonial benefit to a third person;

(c) There must be fraud on the part of the debtor which may be presumed or proved (see Art. 1387.);

(d) The creditor has no other legal remedy to satisfy his claim (see Art. 1383.), that is, he cannot recover his credit in any other manner, it not being required that the debtor be insolvent. (see Art. 1177.)

All these circumstances must concur in a given case. The presence of only one of them is not enough. (Bobis vs. Provincial Sheriff of Camarines Norte, 121 SCRA 28 [1983]; Solis vs. Chua Tria Hermanos, 50 Phil. 636 [1927]; see Art. 1385, par. 2.) While it is necessary that the credit of the plaintiff in the *accion pauliana* must exist prior to the fraudulent alienation, the date of the judgment enforcing it is immaterial. Even if the judgment be subsequent to the alienation, it is merely declaratory with retroactive effect to the date when the credit was constituted. (Siguan vs. Lim, 318 SCRA 725 [1999], citing Tolentino, A.M., Civil Code of the Phils., 1991 Ed., 576-577.)

A person is free to dispose of all his property as absolute owner thereof. The only limitation established by law is that he could not transfer his property to another in fraud of creditors. (Concepcion vs. Sta. Ana, 87 Phil. 787 [1950].) In order that a contract of sale may be rescinded as in fraud of creditors, it is necessary that it be shown that both contracting parties (*e.g.,* vendor and vendee) had acted maliciously and with fraud and for the purpose of prejudicing said creditors. Rescission is generally unavailing should a third person acting in good faith, is in lawful possession of the property, that is to say,

he is protected by law against a suit for rescission by the registration of the transfer to him. Contracts entered into without such mal-intent are not rescissible, even if, as a consequence thereof, the creditor may suffer some damage. The onus of proving by competent evidence the existence of such fraudulent intent on the part of the debtor rests on the creditor seeking rescission. It cannot be presumed from the mere fact that the price paid for property sold is slightly lower than its market value. (Union Bank of the Phils. vs. Ong, 491 SCRA 581 [2006].) If the alienation is by gratuitous title, the fraud is presumed. (see Art. 1387, par. 1.)

Where the fraud charged is not the one used to obtain a party's consent to a contract (Art. 1338.), it can only be a fraud of creditors that gives rise to a rescission of the offending contract. (Goquiolay vs. Sycip, 9 SCRA 663 [1963].)

(4) *Contracts which refer to things under litigation.* — In No. (3), the purpose of the remedy is to secure the payment of an existing credit of a third person against a party to a contract sought to be rescinded. Here, the purpose is to make effective the claim of a party litigant over a thing under litigation which was the object of a contract entered into by the other party with another person.

The right to file the action for rescission arises in favor of the plaintiff when the defendant enters into a contract over the thing in litigation without the knowledge or approval of the plaintiff or the court.

EXAMPLE:

S sues B for the recovery of a parcel of land. In this case, the land is a "thing under litigation."

If, during the pendency of the case, B sells the land to C without the approval of S or of the court, the sale is rescissible at the instance of S in case he wins in his suit for the recovery of said land unless C is in legal possession of the land in good faith. (Art. 1385, par. 2.) S, however, may protect his right by filing a notice of *lis pendens.* (Sec. 14, Rule 13, Rules of Court.)

If the action involves personal property, S may petition the court for the issuance of an order of attachment (Secs. 1, 2, Rule 57, *Ibid*.) or the appointment of a receiver (Sec. 1, Rule 59, *Ibid*.) to place the property in *custodia legis.*

ILLUSTRATIVE CASE:

*The contract in question was executed by debtor after a judgment had been rendered against him. (see Art. 1387, par. 2.)*

*Facts:* The spouses H and W mortgaged to B (bank) the property in question in order to defeat the effectiveness of the decision declaring 1/2 as belonging to C, and to frustrate the collection of the monetary claims of C for which H and W were sentenced to pay.

*Issue:* Is Article 1381 applicable?

*Held:* Yes. Paragraph 3 of Article 1381 is applicable, it appearing that C was not able to collect said monetary claims in view of the third party claim filed by B based on the deed of mortgage in question. Said deed as to the 1/2 belonging to the spouses must, therefore, be cancelled and rescinded.

Although there is no direct evidence to the effect that they executed the deed with the purpose of defrauding C, said purpose may, however, be deduced from the fact that the deed was executed after an adverse decision had been rendered against them. But if any doubt is to be entertained as to the applicability of paragraph 3, there cannot be any question as to the applicability of paragraph 4 of the same article.

The deed of mortgage in question has for its object a property in litigation, and it was executed by H and W without the knowledge and approval of neither the plaintiff (C) nor the court having cognizance of the litigation. *(Contreras and Gingco vs. China Banking Corp., 70 Phil. 709 [1940].)*

(5) *Other instances.* — Some of the specific contracts subject to rescission are as follows:

"Art. 1098. A partition, judicial or extrajudicial, may also be rescinded on account of lesion, when any one of the co-heirs received things whose value is less, by at least one-fourth, than the share to which he is entitled, considering the value of the things at the time they were adjudicated."

"Art. 1470. Gross inadequacy of price does not affect a contract of sale, except as it may indicate a defect in the consent, or that the parties really intended a donation or some other act or contract." (n)

"Art. 1659. If the lessor or the lessee should not comply with the obligations set forth in Articles 1654 [referring to obligations of the lessor] and 1657 [referring to obligations of the lessee], the

aggrieved party may ask for the rescission of the contract and indemnification for damages, or only the latter, allowing the contract to remain in force."

Under Article 1539, the vendee may exercise the remedy of rescission, when the lack in the area of the real estate sold be not less than one-tenth of that stated or when the inferior value of the thing sold exceeds one tenth of the price agreed upon. (see also Arts. 1526, 1534, 1539, 1542, 1556, 1560, 1567.)

Under Article 1599, where there is a breach of warranty by the seller, the buyer may, at his election, rescind the contract of sale and refuse to receive the goods or if the goods have already been received, return them or offer to return them to the seller and recover the price or any part thereof which has been paid. The refusal of the buyer to pay the remaining balance of the agreed consideration on the alleged ground of vice or defect in the goods sold, while at the same time possessing and enjoying the same, is untenable both on the grounds of law and equity. (Embee Transportation vs. Camacho, 80 SCRA 77 [1977].)

See Articles 1189, No. 4, 1191, and 1382.

(6) *Violation of right of first refusal.* — The Supreme Court, in a number of cases, upheld the rescission of a deed of sale which violated a right of first refusal granted to one (lessee) of the parties. The prevailing doctrine is that a right of first refusal means identity of terms and conditions to be offered to the lessee and all other prospective buyers and a contract of sale entered into in violation of the right is rescissible under Articles 1380 to 1381(3) (Guzman, Bocaling and Co., Inc. vs. Bonnevie, 206 SCRA 668 [1992]; Equatorial Realty and Development, Inc. vs. Mayfair Theater, Inc., 264 SCRA 483 [1996]; Litonjua vs. L & R Corporation, 320 SCRA 405 [1999]; Riviera Filipina, Inc. vs. Court of Appeals, 380 SCRA 245 [2002].)

Such violation constitutes a valid cause of action enforceable by an action for specific performance. (Parañaque Kings Enterprises, Inc. vs. Court of Appeals, 268 SCRA 727 [1997]; Equatorial Realty and Development, Inc. vs. Mayfair Theater, Inc., 370 SCRA 56 [2001].)

Where there is no showing of bad faith in the part of the vendee, the sale may not be rescinded. The remedy of the person with the right of first refusal is an action for damages against the vendor. (Rosencor Development Corporation vs. Inquing, 354 SCRA 119 [2001].)

**Rescission for breach of contract and rescission by reason of lesion distinguished.**

A distinction must be made between a rescission for breach of contract under Article 1991 and a rescission by reason of lesion or economic prejudice under Article 1381, *et seq.* considering the patent difference in causes and results of either action.

(1) The rescission on account of breach of stipulations is not predicated on injury to economic interests of the party plaintiff but on the *breach of faith* by the defendant, that violates the reciprocity between the parties. It is not a subsidiary action, that is, the action for rescission is not subordinated to anything other than the culpable breach of his obligations by the defendant. The *rescission is a principal action,* retaliatory in character, it being unjust that a party be held bound to fulfill his promises when the other violates his. Hence, the reparation of damages for the breach is purely secondary.

(2) On the contrary, in the rescission by reason of lesion or economic prejudice, the cause of action is subordinated to the *existence of that prejudice, because it is raison d'etre* as well as the measure of the right to rescind. Hence, where the defendant makes good the damages caused, the action cannot be maintained or continued, as expressly provided in Articles 1383 and 1384. But the operation of these two articles is limited to the cases of rescission for lesion enumerated in Article 1381, and does not apply to cases under Article 1191.[5] (Reyes, J.B.L., concurring, Universal Food Corp. vs. Court of Appeals, 33 SCRA 1 [1970]; see Ong vs. Court of Appeals, 310 SCRA 1 [1999]; Price Corporation vs. PAGCOR, 458 SCRA 164 [2005].)

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[5]Under Article 1124 of the old Civil Code, from which Article 1191 was taken, the terms used were "resolve" and "resolution" instead of "rescind" and "rescission." A distinction existed between "resolution" and "rescission," the former being a principal action by a party to a reciprocal obligation, based on non-performance by the other party even in a unilateral obligation (now Art. 1191.), while the latter, a subsidiary action which may be demanded by a party or even by a third person prejudiced by a contract for any of the causes or grounds specified by law (now Arts. 1380, 1381, 1382, 1383.) In the rescission of reciprocal obligations under Article 1191, based on a breach by a party, the court may grant a period or term for the performance of the obligation, while in rescission of contracts for lesion under Arts. 1380, et seq., the court has no power to grant an extension for performance.

The present Code uses also the term "rescission" when referring to "resolution" under Article 1191. Both presuppose contracts validly entered into and subsisting and both create the obligation of mutual restitution when proper.

From the foregoing, it is clear that rescission under Article 1191 is a principal action, while rescission under Article 1383 is a subsidiary action. The former is based on breach by the other party that violates the reciprocity between the parties, while the latter is not. (Cannu vs. Galang, 459 SCRA 80 [2005].)

According to the Code Commission, however, the provisions of Chapter 6 on rescissible contracts are intended to regulate all such contracts. This is shown not only by the enumeration in the first four numbers but by the all-inclusive wording of number 5 which speaks of "all other contracts x x x" in Article 1381. (Memorandum of the Code Commission, March 8, 1951, p. 21.)

**ART. 1382. Payments made in a state of insolvency for obligations to whose fulfillment the debtor could not be compelled at the time they were effected, are also rescissible. (1292)**

**Payments made in a state of insolvency.**

The present article speaks of "payments" not exactly of a contract. A debtor is insolvent if he does not have sufficient properties to meet his obligations. It is not necessary that debtor's insolvency be judicially declared.

Under this article, the payments must have been made "for obligations to whose fulfillment the debtor could not be compelled at the time they were effected." Such payments are also rescissible.[6] Included in the obligations referred to are not only those that have not yet become due and demandable (*i.e.*, obligations with a suspensive period or condition) but also those which cannot legally be demanded such as natural obligations and those that have prescribed. (see Asia

[6]Under Section 70 of the Insolvency Law (Act No. 1956, as amended.), any payment, pledge, mortgage, sale, assignment, or transfer of property made by an insolvent within 30 days before the filing of a petition insolvency by or against him with a view to giving a preference to any creditor or person having a claim against him, shall be considered fraudulent and void, not merely voidable. Unlike Article 1381 that deals with a valid but rescissible contract, Section 70 treats of a contractual infirmity resulting in nullity of the transaction in question. It specifically makes reference to conveyance of properties made by a "debtor" or by an "insolvent" who filed a petition, or against whom a petition for insolvency has been filed. It does not apply to those transactions made in good faith and for valuable pecuniary consideration. (Union Bank of the Phils. vs. Ong, 491 SCRA 581 [2006].)

Banking Corp. vs. Noble Jose and Lichauco & Co., 51 Phil. 763 [1928]; Asia Banking Corp. vs. Corcuera, 51 Phil. 781 [1928].)

**ART. 1383. The action for rescission is subsidiary; it cannot be instituted except when the party suffering damage has no other legal means to obtain reparation for the same. (1294)**

## Nature of action for rescission.

Rescission of contracts under Article 1383 should be distinguished from rescission of reciprocal obligations under Article 1191. Although both presuppose contracts validly entered into and subsisting and both require mutual institution when proper, they are not entirely identical. (Ong vs. Court of Appeals, 310 SCRA 1 [1999].)

(1) Rescission under article 1383 is not a principal remedy.[7] It is only subsidiary and can be availed of only if the injured party proves that he has no other legal means aside from rescinding the contract to obtain satisfaction for his claim or redress for the damage caused[8] (see Art. 1177.) even if the contract is covered by Article 1381. Thus, in a deed of sale with a deed of mortgage to secure payment of the balance of the purchase price, which grants to the vendor-mortgagee the right to foreclose "in the event of failure of the vendee-mortgagor to comply with any provision of this mortgage," the action for rescission cannot be instituted in case of breach of obligation, in view of the presence of the remedy of foreclosure accorded not only by law but under the contract between the parties. (Suria vs. Intermediate Appellate Court, 151 SCRA 661 [1987]; see Art. 1191.)

(2) If the damage is repaired, as in the case of lesion suffered by the ward or absentee, rescission cannot take place.

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[7]Rescission under Article 1191 is applicable to reciprocal obligations. It is a principal action based on breach by a party of his obligation.

[8]"The following successive measures must be taken by a creditor before he may bring an action for rescission of an allegedly fraudulent sale: (1) exhaust the properties of the debtor through levying by attachment and execution upon all the property of the debtor, except such as are exempt by law from execution; (2) exercise all the rights and actions of the debtor, save those personal to him *(accion subrogatoria);* and (3) seek rescission of the contracts executed by the debtor in fraud of their rights *(accion pauliana):* Without availing of the first and second remedies, *i.e.*, exhausting the properties of the debtor or subrogating themselves in Francisco Bareng's transmissible rights and actions, petitioners simply undertook the third measure and filed an action for annulment of the sale. This cannot be done." (Adorable vs. Court of Appeals, 319 SCRA 200 [1999].)

(3) A rescissible contract may be assailed directly only by a proper action in court, and not indirectly or collaterally by way of defense. An independent action is necessary to prove that a contract is rescissible. It may not be raised or set up in a summary proceeding through a motion. (Air France vs. Court of Appeals, 245 SCRA 485 [1995].)

**ART. 1384. Rescission shall be only to the extent necessary to cover the damages caused. (n)**

## Extent of rescission.

The entire contract need not be set aside by rescission if the damage can be repaired or covered by partial rescission. The rescission shall only be to the extent of the creditor's unsatisfied credit. The policy of the law is to preserve or respect the contract, not to extinguish it.

EXAMPLES:

(1) G, the guardian of M, a minor was authorized by the court to sell two parcels of land valued at P200,000.00 each. G sold the two properties to B for only P200,000.00.

In this case, the entire contract need not be rescinded. Rescission may properly be applied only to one parcel to cover the damage caused by G. (see Art. 1381[1].) But if G or B is willing to pay the difference of P200,000.00, rescission is precluded.

(2) S sold his only property, a parcel of land with an area of 3,000 square meters, to B to defraud C, a creditor of S.

If the value of 1/3 of the land is sufficient to cover the damage caused to C, then the rescission shall only be to that extent. The alienation with respect to the 2/3 portion is valid even if B had acted in bad faith.

Under Article 1384, only the creditor who brought action for rescission benefit from the rescission; those who are strangers to the action cannot benefit from its effects. (Siguan vs. Lim, 318 SCRA 725 [1999].)

**ART. 1385. Rescission creates the obligation to return the things which were the object of the contract, together with their fruits, and the price with its interest; consequently, it can be carried out only when he who demands rescission can return whatever he may be obliged to restore.**

**Neither shall rescission take place when the things which are the object of the contract are legally in the possession of third persons who did not act in bad faith.**

**In this case, indemnity for damages may be demanded from the person causing the loss. (1295)**

**Effect of rescission.**

(1) *Obligation of mutual restitution.* — Rescission creates the obligation of mutual restitution. There is no obligation to restore if nothing has been received. When the court declares a contract rescinded, the parties must return to each other (a) the object of the contract with its fruits and (b) the price thereof with legal interest. For example, in a contract of sale rescinded by the buyer, the seller has the obligation to return the purchase price or amount received plus legal interest from the date he received notice of rescission up to the date of the return.

The purpose of rescission is to place the parties as far as practicable in their original situation, that is, the parties are restored to the *status quo ante*. (see Barredo vs. Leaño, 431 SCRA 106 [2004].). The law presumes that the party who received the object of the contract has enjoyed the fruits thereof while the other has used the money which is the price of the object.

With respect to the fruits, the rules on possession govern. (see Art. 544, *et seq.*) The word "fruits," as used in Article 1385, should be deemed to include not only natural, civil, and industrial fruits but also the accessions and accessories of the things to be returned. (see Arts. 1164, 1166.)

The rule in Article 1385 has been applied to rescission of reciprocal obligations under Article 1191. (Co vs. Court of Appeals, 312 SCRA 528 [1999]; Laperal vs. Solid Homes, Inc., 460 SCRA 375 [2005].) When it is no longer possible to return the object of the contract, an indemnity for damages operates as restitution. The important consideration is that the indemnity for damages should restore to the injured party what was lost. (Coastal Pacific Trading, Inc. vs. Southern Rolling Mills, Co., Inc., 497 SCRA 11 [2006].)

(2) *Abrogation of contract.* — When a rescission is granted, it has the effect of abrogating the contract in all respects. The party seeking rescission cannot ask performance as to part and rescission as to

remainder (Grace Park Engineering Co., Inc. vs. Dimaporo, 107 SCRA 266 [1981].) except as provided in Article 1384.

Article 1385 embodies the precept in Article 1398 in reference to annulment of contracts. (Bucoy vs. Paulino, 23 SCRA 248 [1968].)

(3) *Obligation of third person to restore.* — The clause "he who demands rescission" applies also to a third person. Of course, if the third person has nothing to restore, the article does not apply. The law does not require the impossible. (Memorandum of the Code Commission, March 8, 1951, p. 20.) Thus, where a contract is rescinded on the ground that it has been entered into in fraud of creditors, the plaintiff-creditor has no obligation to return anything since he has received nothing.

ILLUSTRATIVE CASE:

*Lessor sold property leased to a third party in violation of the "exclusive option to purchase the same," given to lessee who filed a suit for specific performance and annulment of the sale.*

*Facts:* Respondent MT, Inc. leased portions of a commercial building together with the land owned by CB, lessor, which it used as a movie theater. Under two contracts of lease *inter alia*, MT, Inc. "shall be given 30-days exclusive option to purchase the same," if CB should desire to sell the leased premises.

CB sold the building to ERD, petitioner, which received rents from MT, Inc. for sometime.

Subsequently, MT, Inc., claiming it had been denied its right to purchase the leased property in accordance with the lease contracts with CB, filed a suit for specific performance and annulment of sale with prayer to enforce its "exclusive option to purchase" the property.

The dispute between MT, Inc., CB and ERD reached the Supreme Court (referred to as "Mother case") which rescinded the absolute sale to ERD, ordered CB to return to ERD the purchase price, directed ERD to execute the documents necessary to return ownership of the disputed lots to CB, and ordered CB to allow MT, Inc. to buy the said lots for P11,300,000. This decision became final and executory on March 17, 1997.

MT, Inc. filed with the trial court a motion for execution which was granted. Subsequently, the Clerk of Court of the Manila Regional Trial Court, as Sheriff, executed a deed of conveyance in favor of CB and a deed of sale in favor of MT, Inc. On the basis of these documents, the Registry

of Deeds of Manila cancelled ERD's titles and issued new certificates of title in the name of MT, Inc.

On September 18, 1997, or after the execution of the decision of the Supreme Court, ERD filed with the Regional Trial Court an action for collection of a sum of money, to wit: (1) the sum of P11,548,941.76 plus legal interest, representing the total amount of unpaid monthly rentals/ reasonable compensation from June 1, 1987 to July 31, 1997; (2) the sums of P849,567.12 and P458,853.44 a month, plus legal interest as rental/ reasonable compensation for the use and occupation of the property from August 1, 1997 to May 1, 1997; and (3) the sum of P500,000 as and for attorney's fees, plus other expenses of litigation, and the costs of the suit.

*Issue:* Is ERD entitled to back rentals?

*Held:* No. (1) *ERD never took actual control and possession of the property sold to it.* — "From the peculiar facts of this case, it is clear that petitioner never took *actual control* and *possession* of the property sold, in view of respondent's timely objection to the sale and the continued actual possession of the property. The objection took the form of a court action impugning the sale which, as we know, was rescinded by a judgment rendered by this Court in the mother case. It has been held that the execution of a contract of sale as a form of constructive delivery is a legal fiction. It holds true only when there is no impediment that may prevent the passing of the property from the hands of the vendor into those of the vendee. When there is such impediment, "fiction yields to reality — the delivery has not been effected.

Hence, respondent's opposition to the transfer of the property by way of sale to ERD's was a legally sufficient impediment that effectively prevented the passing of the property into the latter's hands."

(2) *ERD did not acquire rights to the fruits of the property.* — "x x x However, the point may be raised that under Article 1164 of the Civil Code, ERD as buyer acquired a right to the fruits of the thing sold from the time the obligation to deliver the property to petitioner arose. That time arose upon the perfection of the Contract of Sale on July 30, 1978, from which moment the laws provide that the parties to a sale may reciprocally demand performance. Does this mean that despite the judgment rescinding the sale, the right to the fruits belonged to, and remained enforceable by, ERD?

Article 1385 of the Civil Code answers this question in the negative, because '[r]escission creates the obligation to return the things which were the object of the contract, together with their fruits, and the price

with its interest; x x x.' Not only the land and building sold, but also the rental payments paid, if any, had to be returned by the buyer."

(3) *Rental payments by MT, Inc. did not mean recognition of ERD's title.* — "The fact that MT, Inc. paid rentals to ERD's during the litigation should not be interpreted to mean either actual delivery or *ipso facto* recognition of ERD's title. ERD as alleged buyer of the disputed properties and as alleged successor-in-interest of CB rights as lessor — submitted two ejectment suits against MT, Inc. Filed in the Metropolitan Trial Court of Manila, the *first* was docketed as Civil Case No. 121570 on July 9, 1987; and the *second,* as Civil Case No. 131944 on May 28, 1990. MT, Inc. eventually won them both. However, to be able to maintain physical possession of the premises while awaiting the outcome of the mother case, it had no choice but to pay the rentals. The rental payments made by MT, Inc., should not be construed as a recognition of ERD as the new owner. They were made merely to avoid imminent eviction."

(4) *General principle that rescissible contract is valid until rescinded not applicable.* — "At bottom, it may be conceded that, theoretically, a rescissible contract is valid until rescinded. However, this *general* principle is not decisive to the issue of whether ERD ever acquired the right to collect rentals. What is decisive is the civil law rule that ownership is acquired, not by mere agreement, but by tradition or delivery. Under the factual environment of this controversy as found by this Court in the mother case, ERD was never put in actual and effective control or possession of the property because of MT, Inc. timely objection.

As pointed out by Justice Holmes, general propositions do not decide specific cases. Rather, 'laws are interpreted in the context of the peculiar factual situation of each case. Each case has its own flesh and blood and cannot be decided on the basis of isolated clinical classroom principles.'"

(5) *Sale of ERD not consummated.* — "In short, the sale to ERD may have been valid from inception, but it was judicially rescinded before it could be consummated. Petitioner never acquired ownership, not because the sale was void, as erroneously claimed by the trial court, but because the sale was not consummated by a *legally effective* delivery of the property sold."

(6) *Benefits precluded by ERD's bad faith.* — "Furthermore, assuming for the sake of argument that there was valid delivery, petitioner is not entitled to any benefits from the 'rescinded' Deed of Absolute Sale because of its bad faith. This being the law of the mother case decided in 1996, it may no longer be changed because it has long become final and executory. x x x

On the part of ERD, it *cannot be a buyer in good faith* because it bought the property with notice and full knowledge that MT, Inc. had a right to or interest in the property superior to its own. CB and ERD took unconscientious advantage of MT, Inc.

In the mother case, this Court categorically denied the payment of interest, a fruit of ownership. By the same token, rentals, another fruit of ownership, cannot be granted without mocking this Court's *en banc* Decision, which has long become final.

Petitioner's claim of reasonable compensation for respondent's use and occupation of the subject property from the time the lease expired cannot be countenanced. If it suffered any loss, petitioner must bear it in silence, since it had wrought that loss upon itself. Otherwise, bad faith would be rewarded instead of punished." *(Equatorial and Realty Development, Inc. vs. Mayfair Theater, Inc., 370 SCRA 56 [2001].)*

*Dissenting Opinion (Vitug, J.):*

(1) *Remedy of rescission under Articles 1381 and 1191 distinguished.* — "The remedy of rescission in the case of rescissible contracts under Article 1381 is not to be confused with the remedy of rescission, or more properly termed 'resolution,' of reciprocal obligations under Article 1191 of the Civil Code. While both remedies presuppose the existence of a juridical relation that, once rescinded, would require mutual restitution, it is basically, however, in this aspect alone when the two concepts coincide.

Resolution under Article 1191 would totally release each of the obligors from compliance with their respective covenants. It might be worthwhile to note that in some cases, notably *Ocampo vs. Court of Appeals*, and *Velarde vs. Court of Appeals*, where the Court referred to rescission as being likened to contracts which are deemed '*void at inception*,' the focal issue is the breach of the obligation involved that would allow *resolution* pursuant to Article 1191 of the Civil Code. The obvious reason is that when parties are reciprocally bound, the refusal or failure of one of them to comply with his part of the bargain should allow the other party to resolve their juridical relationship rather than to leave the matter in a state of continuing uncertainty. The result of the resolution, when decreed, renders the reciprocal obligations inoperative 'at inception.'

Upon the other hand, the rescission of a rescissible contract under Article 1381, taken in conjunction with Article 1385, is a relief which the law grants for the protection of a contracting party or a third person, from injury and damage that the contract may cause, or to protect some incompatible and preferential right created by the contract. Rescissible

contracts are not void *ab initio,* and the principle, '*quod nullum est nullum producit effectum*,' in void and inexistent contracts is inapplicable. Until set aside in an appropriate action, rescissible contracts are respected as being legally valid, binding and in force. It would be wrong to say that rescissible contracts produce no legal effects whatsoever and that no acquisition or loss of rights could meanwhile occur and be attributed to the terminated contract. The effects of the rescission, prospective in nature, can come about only upon its proper declaration as such."

(2) *Agreement between ERD and CB efficacious until rescinded.* — "Thus, when the Court held the contract to be 'deemed rescinded' in G.R. No. 106063, the Court did not mean a 'declaration of nullity' of the questioned contract. The agreement between petitioner and CB being efficacious until rescinded, validly transferred ownership over the property to petitioner from the time the deed of sale was executed in a public instrument on 30 July 1978 up to the time that the decision in G.R. No. 106063 became final on 17 March 1997. It was only from the latter date that the contract had ceased to be efficacious. The fact that the subject property was in the hands of a lessee, or for that matter of any possessor with a juridical title derived from an owner, would not preclude a conferment of ownership upon the purchaser nor be an impediment from the transfer of ownership from the seller to the buyer."

(3) *ERD, as owner, entitled to all incidents of ownership.* — "Petitioner, being the owner of the property (and none other) until the judicial rescission of the sale in its favor, was entitled to all incidents of ownership inclusive of, among its other elements, the right to the fruits of the property. Rentals or rental value over that disputed property from 30 July 1978 up to 17 March 1997 should then properly pertain to petitioner. In this respect, the much abused terms of 'good faith' or 'bad faith' play no role; ownership, unlike other concepts, is never described as being either in good faith or in bad faith."

*Dissenting Opinion (Sandoval-Gutierrez, J.):*

(1) *Right of ownership transferred from CB to ERD.* — "x x x For one, this Court, in disposing of G.R. No. 106063, explicitly ordered ERD to '*execute the deeds and documents necessary to return ownership to Carmelo & Bauerman of the disputed lots*.' I suppose this Court would not have made such an order if it did not recognize the transfer of ownership from CB to ERD under the contract of sale. For why would the Court order ERD to execute the deeds and documents necessary *to return ownership* to CB if, all along, it believed that ownership remained with CB?

Furthermore, this Court explicitly stated in the Decision that ERD received rentals from MT, Inc. during the pendency of the case. x x x

Obviously, this Court acknowledged the delivery of the property from CB to ERD. As aptly described by Justice Panganiban himself, the sale between CB and ERD had not only been 'perfected' but also 'consummated.'

That actual possession of the property was turned over by CB to ERD is clear from the fact that the latter received rents from MT, Inc. Significantly, receiving rentals is an exercise of actual possession. x x x When MT, Inc. paid its monthly rentals to ERD, the said lessee recognized the superior right of ERD to the possession of the property. And even if MT, Inc. did not recognize ERD's superior right over the disputed property, the fact remains that ERD was then enjoying the fruits of its possession. x x x Undoubtedly, MT, Inc.'s. possession is by virtue of juridical title under the contract of lease, while that of ERD is by virtue of its right of ownership under the contract of sale.''

(2) *MT, Inc.'s. possession not under a claim of ownership.* — "x x x [G]ranting *arguendo* that there was indeed no actual delivery, would MT, Inc.'s. alleged '*timely objection to the sale and continued actual possession of the property*' constitute an '*impediment*' that may prevent the passing of the property from CB to ERD?

I believe the answer is no.

The fact that MT, Inc. has remained in 'actual possession of the property,' after the perfection of the contract of sale between CB and ERD up to the finality of this Court's Decision in G.R. No. 106063 (and even up to the present), could not prevent the consummation of such contract. As I have previously intimated, MT, Inc.'s. possession is not under a claim of ownership. It cannot in any way clash with the ownership accruing to ERD by virtue of the sale. The principle has always been that the one who possesses as a mere holder acknowledges in another a superior right or right of ownership. A tenant possesses the thing leased as a mere holder, so does the usufructuary of the thing in usufruct; and the borrower of the thing loaned in commodatum. None of these holders asserts a claim of ownership in himself over the thing. Similarly, MT, Inc. does not claim ownership, but only possession as a lessee with the prior right to purchase the property.''

(3) *Right of MT, Inc. is merely to buy property upon rescission of contract of sale.* — "In G.R. No. 106063, MT, Inc.'s. main concern in its action for specific performance was the recognition of its right of first refusal. Hence, the most that MT, Inc. could secure from the institution of its suit was to be allowed to exercise its right to buy the property upon rescission of the contract of sale. Not until MT, Inc. actually exercised what it was allowed to do by this Court in G.R. No. 106063, specifically to buy the disputed

property for P11,300,000.00, would it have any right of ownership. How then, at that early stage, could MT, Inc.'s. action be an impediment in the consummation of the contract between CB and ERD?"

(4) *ERD has right to be paid monthly rentals during existence of contract of sale.* — "x x x I maintain that ERD has the right to be paid whatever monthly rentals during the period that the contract of sale was in existence *minus the rents already paid.* In *Guzman vs. Court of Appeals*, this Court decreed that upon the purchase of the leased property and proper notice by the vendee, the lessee must pay the agreed monthly rentals to the new owner since, by virtue of the sale, the vendee steps into the shoes of the original lessor to whom the lessee bound himself to pay. His belief that the subject property should have been sold to him does not justify the unilateral withholding of rental payments due to the new owner of the property. It must be stressed that under Article 1658 of the Civil Code, there are only two instances wherein the lessee may suspend payment of rent, namely: in case the lessor fails to make the necessary repairs or to maintain the lessee in peaceful and adequate enjoyment of the property leased. In this case, the fact remains that MT, Inc. occupied the leased property. It derived benefit from such occupation, thus, it should pay the corresponding rentals due. *Nemo cum alterius detrimento locupletari potest.* No one shall enrich himself at the expense of another."

(5) *Presence of bad faith should not prevent award of sent to ERD.* — "Neither should the presence of bad faith prevent the award of rent to ERD. While ERD committed bad faith in entering into the contract with CB, it has been equitably punished when this Court rendered the contract rescissible. That such bad faith was the very reason why the contract was declared rescissible is evident from the Decision itself. To utilize it again, this time, to deprive ERD of its entitlement to the rent corresponding to the period during which the contract was supposed to validly exist, would not only be unjust, it would also disturb the very nature of a rescissible contract."

(6) *Sale to ERD not void merely rescissible.* — "In G.R. No. 106063 (involving MT, Inc.'s. suit for specific performance), this Court clearly characterized the Deed of Absolute Sale between CB and petitioner ERD as a rescissible contract. x x x This Court did not declare the Deed of Absolute Sale between CB and ERD void but merely rescissible. Consequently, the contract was, at inception, valid and naturally, it validly transferred ownership of the subject property to ERD. It bears emphasis that ERD was not automatically divested of its ownership. Rather, as clearly directed in the dispositive portion of our Decision, CB should return the purchase price to ERD which, in turn, must execute such deeds and documents necessary to enable CB to reacquire its ownership of the property.

As mentioned earlier, MT, Inc. deposited with the Regional Trial Court, Branch 7, Manila, the purchase price of P10,452,000.00 (P11,300,000.00 less P847,000.00 as withholding tax). In turn, the Clerk of Court executed the deed of sale of the subject property in favor of MT, Inc. In the meantime, MT, Inc. has continued to occupy and use the premises, the reason why ERD filed against it Civil Case No. 97-85141 for sum of money representing rentals and reasonable compensation."

(7) *ERD as owner, has right to payment of rentals.* — "ERD purchased the subject property from CB and became its owner on July 31, 1978. While the contract of sale was 'deemed rescinded' by this Court in G.R. No. 106063, nevertheless the sale had remained valid and binding between the contracting parties until March 17, 1997 when the Decision in G.R. No. 106063 became final. Consequently, being the owner, ERD has the right to demand from MT, Inc. payment of rentals corresponding to the period from July 31, 1978 up to March 17, 1997.

Records show that the rentals and reasonable compensation which ERD demands from MT, Inc. are those which accrued from the year *1987* to *1998*. As earlier stated, prior thereto, MT, Inc. had been paying the rents to ERD. In line with this Court's finding that ERD was the owner of the disputed property from July 31, 1978 to March 17, 1997, it is, therefore, entitled to the payment of rentals accruing to such period."

**When rescission not allowed.**

Under Article 1385:

(1) Mutual restitution is required in rescission and this presupposes that both parties may be restored to their original situation. Hence, the remedy of rescission cannot be availed of if the party who demands rescission cannot return what he is obliged to restore under the contract. (par. 1.)

(2) Neither shall rescission take place, if the property is legally in the possession of a third person who acted in good faith (par. 2.), that is to say, he acquired the property and registered it in the Registry of Property unaware of the flaw in his title or mode of acquisition.[9]

[9]Art. 559. The possession of movable property acquired in good faith is equivalent to a title. Nevertheless, one who has lost any movable or has been unlawfully deprived thereof, may recover it from the person in possession of the same.

If the possessor of a movable lost or of which the owner has been unlawfully deprived, has acquired it in good faith at a public sale, the owner cannot obtain its return without reimbursing the price paid therefor. (464a)

(see Soler vs. Chesley, 43 Phil. 529 [1922]; Cordovero and Alcazar vs. Villaruiz and Borromeo, 46 Phil. 473 [1924]; Sikatuna vs. Guevara and Francisco, 43 Phil. 471 [1922].) In such case, the remedy would be to demand indemnity for damages from the person who caused the loss. (par. 3.)

If the alienation is gratuitous and not by onerous title (see Art. 1387.), the transferee cannot invoke good faith, otherwise, he would enrich himself at the expense of the creditor.

**Rescission different from mutual dissent.**

Rescission must be distinguished from mutual dissent where the parties agree to cancel their contract and mutually return the object and cause thereof.

Article 1385 refers to contracts that are rescissible for causes specified in Articles 1381 and 1382 but it does not refer to contracts that are dissolved by mutual consent of the parties. Rather, the mutual restoration is in consonance with the basic principle that when an obligation has been extinguished or resolved, it is the duty of the court to require the parties to surrender whatever they may have received from the other so that they may be restored as far as practicable to their original situation. (Floro Enterprises, Inc. vs. Court of Appeals, 249 SCRA 354 [1995].)

ILLUSTRATIVE CASE:

*Applicability of Article 1385 to contracts "rescinded" by mutual consent.*

*Facts:* B, on account of having purchased lands from S, took possession of the same and collected their products. Subsequently, B and S, by virtue of another contract, "rescinded" the sale, and as a result thereof, B returned the lands to S who, in turn, bound himself to return to B the part of the price that the latter has paid.

*Issue:* Is B obliged to return to S the products of the land that B collected during his possession?

*Held:* No. Rescission, in the light of Articles 1381, 1382, and 1385, is a relief which the law grants, on the premise that the contract is valid, for the protection of one of the contracting parties and third persons from any injury and damage the contract may cause, or to protect some incompatible and preferential rights created by the contract. Article 1385 refers to contracts that are rescissible in accordance with law in the cases expressly fixed thereby but does not refer to contracts that are rescinded

by mutual consent and for the mutual convenience of the contracting parties.

The rescission in question did not originate in any of the causes specified in Articles 1381 and 1382, nor is it any relief for the purposes sought by these articles. Its effects should be determined by the agreement of the parties or by the application of other legal provisions not by Article 1385.

The possession of B, until the contract of sale was dissolved, and the lands returned by him, was in good faith. As such possessor in good faith, he is entitled to the fruits received before his possession was legally interrupted (Art. 541.), and, therefore, he is not obliged to return them to B in the absence of any covenant. (*Aquino vs. Tanedo, 39 Phil. 517 [1919];* see PAGCOR vs. Court of Appeals, 231 SCRA 354 [1994].)

**ART. 1386. Rescission referred to in Nos. 1 and 2 of Article 1381 shall not take place with respect to contracts approved by the courts. (1296a)**

### Contracts approved by the courts.

If a contract entered into in behalf of a ward or absentee has been approved by the court, rescission cannot take place because it is valid whether there is lesion or not.

The law presumes that the court is acting in the interests of the ward or absentee when it approves the contract in spite of the lesion. (see Sec. 1, Rule 95, Rules of Court.)

**ART. 1387. All contracts by virtue of which the debtor alienates property by gratuitous title are presumed to have been entered into in fraud of creditors, when the donor did not reserve sufficient property to pay all debts contracted before the donation.**

**Alienations by onerous title are also presumed fraudulent when made by persons against whom some judgment has been rendered in any instance or some writ of attachment has been issued. The decision or attachment need not refer to the property alienated, and need not have been obtained by the party seeking the rescission.**

**In addition to these presumptions, the design to defraud creditors may be proved in any other manner recognized by the law of evidence. (1297a)**

**When alienation presumed in fraud of creditors.**

The general rule is that fraud is not presumed. As fraud is criminal in nature, it must be proved by clear and preponderance of evidence. (Bobis vs. Provincial Sheriff of Camarines Norte, 121 SCRA 28 [1983].)

(1) *Instances not exclusive.* — Article 1387 establishes presumptions of fraud in the case of alienation by the debtor of his property. (pars. 1 and 2.) However, the instances mentioned are not exclusive of others that may be proved in any other manner recognized by the law of evidence. (par. 3; see Art. 1177.) The presumptions are disputable and may be rebutted by contrary evidence. *(infra.)*

(2) *Presumption not applicable in the absence of transfer.* — The presumption in Article 1387 applies only when there has in fact been an alienation or transfer, whether gratuitously or by onerous title. (Prov. Sheriff of Pampanga vs. Court of Appeals, 22 SCRA 798 [1968].) The effect of the presumption is to shift the burden to the one who alienated to prove that the transfer was not fraudulently made. (Lim vs. Court of Appeals, 507 SCRA 38 [2006].)

(3) *Only actual creditors can ask for rescission.* — Under the Civil Code (Arts. 1381[3], 1387.), only actual creditors can ask for the rescission of the conveyance made by their debtors in favor of strangers. The waiver and release made previously by the creditor of the credit he held against the debtor operate to deprive the rescissory action of any legal basis. (see Marsman Investments Ltd. vs. Phil. Abaca Development Co., 9 SCRA 783 [1963]; see Panlilio vs. Victorio, 35 Phil. 706 [1916].)

(4) *Vendor, an indispensable party in action for rescission of sale.* — An action for rescission of sale under Article 1387 cannot be finally determined without the presence in court of the vendor. For any decision on the action or claim for damage would affect him. He is entitled to be heard. (see Gigante vs. Republic Savings Bank, 26 SCRA 328 [1968].)

EXAMPLES:

(1) *Alienation by gratuitous title.* — R made a donation of a parcel of land to E. *Before* the date of the donation, R had contracted several debts. With the donation to E, the remaining property of R is not sufficient to pay all his debts. (see Arts. 750, 759.)

Under the first paragraph, the donation is presumed fraudulent unless proved otherwise.

(2) *Alienation by onerous title. —*

(a) Suppose in the preceding example, the contract is a sale.

Under the second paragraph, the sale to E is not presumed fraudulent. The creditors of R must show that the conveyance will prejudice their rights. (Art. 1381, No. 3; see Oria vs. McMicking, 21 Phil. 243 [1912].) However, the presumption of fraud will arise in case the sale was made by R after some judgment has been rendered against him or some writ of attachment has been issued against him. (see De Jesus vs. G. Urrutia & Co., 33 Phil. 171 [1916].)

(b) Suppose again that C, a creditor of R, has obtained a judgment or writ of attachment in his favor. Then R sold to D another parcel of land which has not been levied upon or attached.

The sale to D is also presumed fraudulent because the law says "the decision or attachment need not refer to the property alienated."

(c) E is another creditor of R. Does he have the right to rescind the sale to D?

Yes, because the law says that "the decision or attachment . . . need not have been obtained by the party seeking the rescission."

ILLUSTRATIVE CASES:

1. *What was transferred by the debtor was merely the business name of his store, not the store itself or its furniture.*

*Facts:* A big fire totally burned the furniture store of X and its contents. X was then a furniture dealer under the business name and style "Modern Furniture Store." Not long thereafter, Y, X's brother, put on the same site a new furniture store, adopting the same business name and style. Y secured a new license and privilege tax to operate the store.

On the same date, X verbally transferred the "Modern Furniture Store" to Y. Subsequently, a judgment was rendered against X in favor of Z in an action for recovery of a sum of money filed by Z when X was then a furniture dealer.

*Issue:* Does Article 1387 on presumption of fraud apply?

*Held:* No, since there was in fact no transfer of the store or its furniture or its contents. The transfer refers merely to the business name and style "Modern Furniture Store." The store of Y and its contents are completely new coming from his own capital. *(Provincial Sheriff of Pampanga vs. Court of Appeals, supra.)*

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2. *Purchaser at auction sale of property of his judgment debtor brings suit against latter's son for rescission of transfer of the same property made by the father to the son.*

*Facts:* The house in question was originally entered in the assessment rolls in the name of S, judgment debtor of C to whom the house was sold at public auction pursuant to a writ of execution. Later, it was registered in the name of B son of S who mortgaged it to a bank to secure the payment of a loan. The bank foreclosed the mortgage and bought the land together "with all the buildings and improvements" thereon.

C charges that any transfer by from S to B is fictitious, fraudulent and null and void and claims damages against B and the Bank.

*Issue:* Would the action by C for rescission of the transfer of the house from S to B and the claim for damages prosper?

*Held:* No. The bank's registered mortgage is superior to the judgment and levy and sale in favor of C. Furthermore, S is not a party to the suit against B and the bank. S is an indispensable party. For any decision on either action would affect him. He is entitled to be heard, to defend the validity of the transfer to his son, B. *(Gigante vs. Republic Saving Bank, supra.)*

**Test for determining whether a conveyance is fraudulent.**

"In determining whether or not a certain conveyance is fraudulent, the question in every case is whether the conveyance was a *bona fide* transaction or a trick and contrivance to defeat creditors, or whether it conserves to the debtor a special right.

It is not sufficient that it is founded on good consideration, or is made with *bona fide* intent; it must have both elements. If defective in either of these particulars although good between the parties, it is rescindible as to creditors. The rule is universal both in law and in equity that whatever fraud creates, justice will destroy. The test as to whether or not a conveyance is fraudulent is: Does it prejudice the right of creditors?" (Oria vs. McMicking, 21 Phil. 243 [1912]; see China Banking Corporation vs. Court of Appeals, 327 SCRA 378 [2000].)

**Evidence to overcome presumption of fraud.**

(1) The presumption of fraud established in paragraph 2 is not overcome by the fact that the deeds of sale are in the nature of public

instruments. For the principle that to destroy the validity of an existing public document, strong and convincing evidence necessarily operates "where the action is brought by one party against the other to impugn the contract . . . but that rule cannot operate where the case is one wherein the suit is not between the parties *inter se* but is one instituted by a third person, not a party to the contract but precisely the victim of it because it was executed to his prejudice and behind his back; otherwise, the court would be furnishing a most effective shield of defense to the aggressor." (Cabaliw vs. Sadorra, 64 SCRA 310 [1975].)

(2) In order to overcome this presumption, it is incumbent upon the transferee to establish affirmatively by satisfactory and convincing evidence that the conveyance was executed in good faith for a good and valuable consideration. (see Gana vs. Sheriff of Laguna and Yatco, 36 Phil. 236 [1917]; Oria vs. McMicking, *supra*; China Banking Corporation vs. Court of Appeals, 364 SCRA 638 [2001].) If he fails to do so, the fraudulent nature of the conveyance in question prevails. (Bachrach vs. Peterson, 7 Phil. 571 [1907]; Panlileo vs. Victorio, 35 Phil. 706 [1916]; Alpuerto vs. Perez Pastor, 38 Phil. 785 [1918]; National Exchange Co. vs. Katigbak, 54 Phil. 599 [1930].)

**Circumstances denominated as badges of fraud.**

The existence of fraud may thus be shown by circumstantial evidence. The reason is that direct evidence, of fraud is seldom available "because of the concomitant deceit, deception and cunning, which are usually underhanded and hidden." (Lopez vs. Lopez, [CA] No. 308-R, July 11, 1947.) In the consideration of whether or not certain transfers are fraudulent, courts have laid down certain rules by which the fraudulent character of the transaction may be determined.

The following are some of the circumstances attending sales which have been denominated by the courts as "badges of fraud:"

(1) The fact that the consideration of the conveyance is fictitious or inadequate;

(2) A transfer made by a debtor after suit has been begun and while it is pending against him. (see illustrative case below) It has been held, however, that while inadequacy of price and the pendency of a case against the vendor may be considered badges of fraud, the sale cannot be considered in fraud of creditors in the absence of proof that

the vendor had no other property except that sold, especially where the creditor knew of such sale and did nothing to have it annulled as in fraud of him nor did he cause a cautionary notice to be inscribed in his certificate of title to protect his interest (Bobis vs. Provincial Sheriff of Camarines Norte, 121 SCRA 28 [1983].);

(3) A sale upon credit by an insolvent debtor;

(4) The transfer of all or nearly all of his property by a debtor, especially when he is insolvent or greatly embarrassed financially;

(5) Evidence of large indebtedness or complete insolvency;

(6) The fact that the transfer is made between father and son, when there are present some or any of the above circumstances;

(7) The failure of the vendee to take exclusive possession of the property sold (Oria vs. McMicking, *supra.*), unless such failure is with legal basis or practical reason, as where there exists what appears to be a genuine lessor-lessee relationship between the vendor and the vendee (Union Bank of the Phils. vs. Ong, 491 SCRA 581 [2006].);

(8) At the time of the conveyance, the vendee was living with the vendor and the former knew that there was a judgment against the latter;

(9) It was known to the vendee that the vendor had no properties other than that sold to him (Cabaliw vs. Sadorra, *supra.*);

(10) The certificate of title covering the lands sold remained in the name of the vendor who declared them for taxation purposes and paid the taxes, a duty assumed by his heirs after his death (Castro vs. Escutin, 90 SCRA 349 [1979].);

(11) Where the mortgagor-vendor and mortgagee-vendee are bosom friends with long history of trust and intimacy and the element of trust is further accentuated by the execution between them in addition to the two instruments (*i.e.*, mortgage and subsequently, sale of the property) in question, of two secret documents known as counter-receipt *(contra recibo).* Fraud is generally accompanied by a secret trust, and, as in this case, the ostensible debtor selects a person in whom he can repose trust and confidence *(Ibid.);*

(12) Where the seller and the buyer are half-brothers and the sale was executed and registered about one month after a decision was rendered against the seller. The allegation that the property was sold

two (2) years before the decision by means of a private document is ineffective to avoid the nullity of the sale for a private document can be easily produced with any date which is convenient (Nerona vs. Intermediate Appellate Court, 133 SCRA 837 [1984].); and

(13) Where it appears, among others, that: (a) the sale was in English, the alleged vendor being illiterate; (b) his wife did not join the sale; (c) the price was inadequate; (d) the notarization of the sale was made on the day following the alleged thumb marking of the document; (e) the boundaries of the lot sold were not stated; and (f) the sale was registered more than five (5) years later. (Yanas vs. Acaylar, 136 SCRA 52 [1985].)

The above enumeration is not an exclusive list. When clear and unmistakable, badges of fraud will serve to destroy the camouflage of validity of a contract. Where the sale is fictitious and fraudulent, the action or defense for the declaration of its inexistence does not prescribe. (*Ibid.*, Art. 1410.)

ILLUSTRATIVE CASE:

*The sale by a debtor of property was made while there was a pending suit for collection of money against him.*

*Facts:* S sold to B a lot on January 4, 1956. The sale was inscribed in the land registry on February 15, 1956. Meantime, since November, 1955, there was pending against S a complaint filed by C for the collection of a sum of money. Judgment was rendered in favor of C on February 27, 1956. The land was sold at public auction on October 17, 1956. The sheriff's certificate of sale was executed on October 29, 1956, followed by a definite deed of sale on January 9, 1959 in C's favor.

C seeks to have the prior sale to B set aside on the ground that it was executed in fraud of C upon the presumption set forth in Article 1387.

*Issue:* Does the presumption of fraud apply?

*Held:* No. The judgment obtained by C against S, owner of the land in dispute, was rendered after the sale of the same to B. Nor was a writ of attachment issued. It is true that the sale to B was made after suit had been begun by C against S. This lone circumstance itself alone, however, is not sufficient to prove fraud. There is no showing that B knew of the pending action. *(Gaspar vs. Dorado, 15 SCRA 331 [1965].)*

**Conveyance of property by an insolvent debtor.**

(1) *When valid.* — If a debtor be actually insolvent, he may still dispose of his property for a valuable consideration in good faith. But he will not be permitted to alienate his property and place it in a position where it is not subject to process in behalf of his creditors, unless there had been received a full and fair consideration, and the transfer has been made in good faith. Any transfer made in contemplation of insolvency is invalid under the same circumstances as if made by the debtor actually insolvent.

(2) *Disparity between consideration and real value.* — Gross disparity between the consideration and the actual value of the property conveyed is a badge of fraud. Under such circumstance, it is generally held that equity will, in any event, subject the property conveyed to the claims of creditors to the extent that the real value exceeds the consideration.

(a) If the disparity of the consideration is deliberate, with intent to defraud creditors, the transaction is utterly void as to creditors, and gross disparity may under some circumstances of itself justify the inference that there was fraud. A man must be just before he is generous, and consequently, he will not be permitted to prejudice his creditors by giving away his property for little or nothing.

(b) The courts will not weigh the value of the goods sold and the price received in very nice scales, but all circumstances considered, there should be a reasonable and fair proportion between the one and the other. Inadequacy of price does not mean an honest difference of opinion as to price, but a consideration so far short of real value of the property as to startle a correct mind. (12 R.C.L. 477-479, cited in Asia Banking Corp. vs. Noble Jose and Lichauco & Co., 51 Phil. 763 [1928]; Asia Banking Corp. vs. Corcuera, 51 Phil. 781 [1928].)

**ART. 1388. Whoever acquires in bad faith the things alienated in fraud of creditors, shall indemnify the latter for damages suffered by them on account of the alienation, whenever, due to any cause, it should be impossible for him to return them.**

**If there are two or more alienations, the first acquirer shall be liable first, and so on successively. (1298a)**

**Liability of purchaser in bad faith.**

The purchaser in bad faith, who acquired the object of the contract alienated in fraud of creditors, must return the same if the sale is rescinded (see Art. 1383.) and should it be impossible for him to return it *due to any cause,* he must indemnify the former.

Should there be two or more alienations, the first acquirer shall be liable first, and so on successively.

EXAMPLES:

(1) S sold his car to B in order to avoid the payment of his debt to C, his creditor. B knew of S's purpose.

If the sale is rescinded, B must return the car. Should the car be destroyed with or without his fault, then C is entitled to be indemnified for damages by B.

(2) Suppose, B transferred the car to D who also acted in bad faith. Then D sold it to E who did not know of the purpose behind the previous conveyance.

As the first acquirer. B is liable first. If he cannot pay, then D will be liable.

If B acted in good faith, the good or bad faith of D is not important, except where D connived with S to make B a mere innocent intermediary in which case D can be held liable.

(3) Without making any inquiry, B bought a parcel of land from S, who is not the registered owner, although the land object of the transaction is registered. May B be considered a purchaser in good faith?

No. "One who buys from one who is not the registered owner is expected to examine not only the certificate of title but all factual circumstances necessary for him to determine if there are any flaws in the title of the transferor or in his capacity to transfer the land." (Barrios vs. Court of Appeals, 78 SCRA 427 [1977].)

**Meaning of bad faith.**

*Bad faith* does not simply connote bad judgments or negligence. It imports a dishonest purpose or some moral obliquity and conscious doing of wrong. It means breach of a known duty through some motive or interest or ill-will. It partakes of the nature of fraud. (Board of Liquidators vs. Heirs of M.M. Kalaw, 20 SCRA 987 [1967]; Ong Yiu vs. Court of Appeals, 91 SCRA 233 [1979].)

Bad faith is a state of mind indicated by acts and circumstances and can be demonstrated, not only by direct proof, but also by circumstantial evidence. (De Laig vs. Court of Appeals, 82 SCRA 294 [1978].)

### Meaning of purchaser in good faith.

A *purchaser in good faith* is one who buys the property of another without notice that some other person has a right to, or interest in, such property and pays a full and fair price for the same, at the time of such purchase, or before he has notice of the claim or interest of some other person in the property. (De Recinto vs. Inciong, 77 SCRA 196 [1977].)

A party's mere refusal to believe that a defect exists or his willful closing of his eyes to the possibility of the existence of a defect in his vendor's title, will not make him an innocent purchaser for value, if it afterwards develops that the title was in fact defective. (Barrios vs. Court of Appeals, 78 SCRA 427 [1977]; J.M. Tuazon & Co., Inc. vs. Court of Appeals, 93 SCRA 146 [1979].)

**ART. 1389. The action to claim rescission must be commenced within four years.**

**For persons under guardianship and for absentees, the period of four years shall not begin until the termination of the former's incapacity, or until the domicile of the latter is known. (1299)**

### Period for filing action for rescission.

As a general rule, the action to rescind contracts must be commenced within four (4) years from the date the contract was entered into. The exceptions are:

(1) For persons under guardianship, the period shall begin from the termination of incapacity; and

(2) For absentees, from the time the domicile is known.

Laches (see Title IV.) bars an action for rescission or annulment of a contract. (see Art. 1391.)

### Computation of the four-year period.

Article 1389 is silent as to the date from which the period of four (4) years is to be counted, whether from the celebration of the contract,

or from the time the creditor acquires knowledge of the existence of the contract, or from the moment the cause of action accrues.

(1) The Code Commission has given the opinion that the period should be counted from the time the creditor knows of the contract. This is not only a matter of justice, but is also implied from the last words of paragraph 2, namely, "until the domicile of the latter is known." So long as the absentees' whereabouts are unknown, he cannot possibly know of the contract which is prejudicial to him. (Memorandum of the Code Commission, March 8, 1951, pp. 21-23.)

(2) It is submitted that where the action for rescission is based on fraud (Arts. 1381[3, 4], 1382.), the period must be counted from the time of the celebration of the contract.

(3) In a case decided under Article 1911, where the fulfillment of the obligation of the seller became impossible because of a judgment rendered against the seller, it was held that the action for rescission by the buyer must be commenced within four (4) years from the date the judgment became final and executory as per entry of the judgment. (Ayson-Simon vs. Adamos, 131 SCRA 439 [1984].)

(4) According to the Supreme Court, since Article 1389 is silent as to when the prescriptive period would commence, the general rule, *i.e.*, from the moment the cause of action accrues, applies. Under Article 1150,[10] the time of prescription shall be counted from the day the action may be brought. (Khe Hong Cheng vs. Court of Appeals, 355 SCRA 701 [2001].)

### When action to rescind or *accion pauliana* accrues.

It is the legal possibility of bringing the action which determines the starting point for the computation of the prescriptive period for the action. It is apparent from Article 1383 that an action to rescind or an *accion pauliana* (see Art. 1177.) must be availed of only after all other legal remedies have been exhausted and have been proven futile.

(1) *Requisites.* — For an *accion pauliana* to accrue, the following requisites must concur:

[10]Art. 1150. The time for prescription for all kinds of actions, when there is no special provision which ordains otherwise, shall be counted from the day they may be brought. (1969)

(a) That the plaintiff asking for rescission has a credit prior to the alienation, although demandable later;

(b) That the debtor has made a subsequent contract conveying a patrimonial benefit to a third person;

(c) That the creditor has no other legal remedy to satisfy his claim, but would benefit by rescission of the conveyance to the third person;

(d) That the act being impugned is fraudulent; and

(e) That the third person who received the property conveyed, if by onerous title, has been an accomplice in the fraud.

(2) *Action of last resort.* — An *accion pauliana* accrues only when the creditor discovers that he has no other legal remedy for the satisfaction of his claim against the debtor other than an *accion pauliana.* It is an action of last resort. For as long as the creditor still has a remedy at law for the enforcement of his claim against the debtor, the creditor will not have any cause of action against the debtor for rescission of the contracts entered into by and between the debtor and another person or persons.

(3) *Exhaustion of debtor's property.* — Indeed, an *accion pauliana* presupposes a judgment and the issuance by the trial court of a writ of execution for the satisfaction of the judgment and the failure of the sheriff to enforce and satisfy the judgment of the court. It presupposes that the creditor has exhausted the property of the debtor.

(4) *Priority in time of credit.* — The date of the decision of the trial court against the debtor is immaterial. What is important is that the credit of the plaintiff antedates that of the fraudulent alienation by the debtor of his property. After all, the decision of the trial court against the debtor will retroact to the time when the debtor became indebted to the creditor. (Khe Hong Cheng vs. Court of Appeals, *supra*.)

**Persons entitled to bring the action for rescission.**

The action for rescission may be brought by:

(1) the injured party or the defrauded creditor;

(2) his heirs, assigns, or successors in interest; or

(3) the creditors of the above entitled to subrogation *(accion subrogatoria).* (see Art. 1177.)

**Right of ordinary creditors to sue for rescission.**

An ordinary creditor (*e.g.*, lender) does not have such material interest as to allow him to sue for rescission of a contract of sale of real property by his debtor.

While his right against the seller-debtor is only a personal right[11] to receive payment for the loan, it is not a real right over the property subject of the sale. While he has an interest in securing payment of the loan, such right does not in any manner attach to a particular portion of the patrimony of the debtor. He must first avail of the remedies provided in Article 1177, *i.e.*, exhausting the properties of the debtor or subrogating himself in the debtor's transmissible rights and actions, before he can file an action for annulment or rescission of the sale. (Adorable vs. Court of Appeals, 319 SCRA 200 [1999].)

**Right of compulsory heir to bring action.**

The rights of a compulsory or forced heir to the legitime are similar to a credit of a creditor insofar as the right to the legitime may be defeated by fraudulent contracts. Thus, the compulsory heirs instituted as such by their father in the latter's testament have the undeniable right to institute an action to rescind contracts entered into by the father to their prejudice. (Concepcion vs. Sta. Ana, 87 Phil. 787 [1950], citing Manresa; Armentia vs. Patriarca, 18 SCRA 1253 [1966]; see also Velarde vs. Paz, 101 Phil. 376 [1957].)

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[11]See Comments under Article 1164.

# Chapter 7

# VOIDABLE CONTRACTS

**ART. 1390. The following contracts are voidable or annullable, even though there may have been no damage to the contracting parties:**

**(1) Those where one of the parties is incapable of giving consent to a contract;**

**(2) Those where the consent is vitiated by mistake, violence, intimidation, undue influence or fraud.**

**These contracts are binding, unless they are annulled by a proper action in court. They are susceptible of ratification. (n)**

## Meaning of voidable contracts.

*Voidable* or *annullable contracts* are those which possess all the essential requisites of a valid contract but one of the parties is legally incapable of giving consent, or consent is vitiated by mistake, violence, intimidation, undue influence, or fraud.[1]

Thus, there are only two (2) types of voidable contracts.

## Binding force of voidable contracts.

They are existent, valid and obligatory unless annulled or set aside by a *proper action* in court, *i.e.*, an action instituted for that purpose.

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[1]In a case, the plaintiff declared under oath in her complaint that she signed the deeds of sale in question without knowing what they were, which means according to the Supreme Court, "that her consent was not merely marred by the above-stated vices, so as to make the contract voidable, but that she had not given her consent at all x x x which made the deeds of sale void altogether and rendered them subject to attack at any time, conformably to the rule in Article 1410." (Baranda vs. Baranda, 150 SCRA 59 [1987].)

The sale of conjugal property requires the consent of both the husband and wife. The absence of the consent of one renders the sale null and void, not merely voidable. (see Art. 124, Family Code.) Article 1390, par. 2, refers to contracts vitiated by vices of consent, not those where consent is totally inexistent or absent. (Guiang vs. Court of Appeals, 291 SCRA 372 [1998].)

Once ratified, they become absolutely valid and can no longer be annulled. (see comments under Arts. 1327, 1328, 1330.)

The existence of damage is not essential for their annulment as in the case of rescissible contracts.

**Meaning of annulment.**

*Annulment* is a remedy as well as a sanction provided by law, for reason of public interest, for the declaration of the inefficacy of a contract based on a defect or vice in the consent of one of the contracting parties in order to restore them to their original position in which they were before the contract was executed.

**Differences between action for annulment and action for rescission.**

They are the following:

(1) The first is based on vitiation of consent (Art. 1390.), while the second, on lesion to one of the parties or to a third person (Art. 1381.);

(2) The first may be brought only by a party to the contract (Arts. 1390, 1397.), while the second, also by a third person who suffered damage by reason of the contract (Art. 1381.);

(3) The first is a principal action (Art. 1390.), while the second is merely subsidiary (Art. 1383.);

(4) The first presupposes that the contract is legally defective (Art. 1390.), while the second, that the contract was validly entered into (Art. 1380.);

(5) The first seeks the imposition of sanction by law on the guilty party for reason of public interest *(Ibid.)*, while the second, is a remedy allowed by law on ground of equity (see Art. 1383.);

(6) The first is allowed even if the plaintiff has been indemnified (see Art. 1390.), while the second is barred by such indemnification (Arts. 1383, 1384.)

**ART. 1391. The action for annulment shall be brought within four years.**

**This period shall begin:**

**In cases of intimidation, violence or undue influence, from the time the defect of the consent ceases.**

**In case of mistake or fraud, from the time of the discovery of the same.**

**And when the action refers to contracts entered into by minors or other incapacitated persons, from the time the guardianship ceases. (1301a)**

## Period for filing action for annulment.

*Direct court action* is necessary to annul a voidable contract, and until annulled or set aside by the court, a party cannot relieve himself from the obligations arising therefrom. (see Art. 1410; Rio Grande Rubber Estate Co., Inc. vs. Board of Liquidators, 104 Phil. 863 [1958].) A voidable contract may be collaterally attacked by way of defense to an action under the contract.

The four-year period for bringing an action for annulment is reckoned:

(1) In case of intimidation, violence, or undue influence, from the time the intimidation, etc. ceases. Before that time, the consent is still being vitiated and, therefore, the victim cannot be expected to bring an action in court. (see Rodriguez vs. Rodriguez, 20 SCRA 908 [1967].) The running of the prescriptive period cannot be interrupted by an *extrajudicial demand* made by the party whose consent was vitiated. (Miailhe vs. Court of Appeals, 354 SCRA 675 [2001].)

(2) In case of mistake or fraud, from the time it is discovered.[2] This must be so because before the time of discovery, the innocent party is unaware of the reason which renders the contract voidable (Art. 1393.) and cannot also be expected to bring an action in court. Furthermore, the guilty party should not be rewarded for successfully hiding the mistake or fraud.

The time of the discovery of the alleged mistake or fraud, must be clear from the allegations of the complaint. (Gonzales vs. Climax Mining Ltd., 512 SCRA 148 [2007].)

(3) In the case of contracts entered into by minors or other incapacitated persons, from the time the guardianship ceases. In the case

[2] "To ascertain what constitutes 'a discovery of the facts constituting the fraud,' reference must be had to the principles of equity. In actions in equity, the rule is that the means of knowledge are equivalent to actual knowledge, that is, a knowledge of facts which would have put an ordinarily prudent man upon an inquiry which, if followed up, would have resulted in the discovery of the fraud."

of a minor, guardianship ceases upon reading the age of majority. (see Arts. 1327-1329.) An incapacitated person has no capacity to sue.

A voidable contract, like unenforceable and void contracts *(infra.)*, may be attacked indirectly or collaterally by way of defense. Article 1391 presupposes, however, that no acquisitive prescription has set in, for after the favorable effects of acquisitive prescription have set in, rights of ownership over a property are rendered indisputable. (Heirs of Placido Miranda vs. Court of Appeals, 255 SCRA 368 [1996].)

ILLUSTRATIVE CASE:

*The action for annulment of the contract of sale was brought beyond the 4-year prescriptive period but oral and written extrajudicial demands were made prior thereto.*

*Facts:* Petitioner M was forced, "through threats and intimidation," to sell at a grossly low price his three parcels of land located near Malacañang during the height of martial law to Development Bank of the Philippines (DBP) which, in turn, sold it to the Government, through the Office of the President.

After the late President Marcos left the country on February 14, (sic) 1986 after the EDSA Revolution M made repeated extrajudicial demands upon respondents for the return and reconveyance of subject properties to them, the last being the demand letters dated October 24, 1989.

On March 23, 1990, M filed a complaint for annulment of sale, reconveyance and damages against respondents.

*Issue:* Has the action for annulment of the contract of sale prescribed?

*Held:* Yes. (1) *Alleged threat and intimidation ceased when Marcos left on February 24, 1986.* — "Since an action for the annulment of contracts must be filed within four years from the time the cause of vitiation ceases, the suit before the trial court should have been filed anytime on or before February 24, 1990. In this case, petitioner did so only on March 23, 1990. Clearly, his action had prescribed by then."

(2) *Extrajudicial demands did not interrupt prescription.* — "Petitioner asserts that the extrajudical demands pleaded in paragraph 12 of the Complaint legally interrupted prescription in accordance with Article 1155 of the Civil Code, which states:

> 'ART. 1155. The prescription of actions is interrupted when they are filed before the court, when there is extrajudicial demand by the

creditors, and when there is any written acknowledgment of the debt by the debtor.'

In other words, petitioner claims that because he is covered by the term 'creditor,' the above-quoted provision is applicable to him.

We are not persuaded. Petitioner himself avers that 'the use of the terms 'creditor' and/or 'debtor' in Article 1155 of the Civil Code must relate to the general definition of obligations.' He then asserts that 'an obligation is a juridical relation whereby a person (called the creditor) may demand from another (called the debtor) the observance of a determinate conduct, and in case of breach, may obtain satisfaction from the assets of the latter.' He also defines 'credit' as the right to demand the object of the obligation. From his statements, it is clear that for there to be a creditor and a debtor to speak of, an obligation must first exist.

In the present case, there is as yet no obligation in existence. Respondent has no obligation to reconvey the subject lots because of the existing Contract of Sale. Although allegedly voidable, it is binding unless annulled by a proper action in court. Not being a determinate conduct that can be extrajudically demanded, it cannot be considered as an obligation either. Since Article 1390 of the Civil Code states that voidable 'contracts are binding, *unless they are annulled by a proper action in court*,' it is clear that the defendants were not obligated to accede to any extrajudicial demand to annul the Contract of Sale.

In the absence of an existing obligation, petitioner cannot be considered a creditor, and Article 1155 of the Civil Code cannot be applied to his action. Thus, any extrajudicial demand he made did not, or will not, interrupt the prescription of his action for the annulment of the Contract of Sale." *(Miailhe vs. Court of Appeals, 354 SCRA 675 [2001].)*

**Time for reckoning discovery of fraud.**

In legal contemplation, discovery of fraud must be reckoned to have taken place from the execution of the contract if there is an allegation that it did not reflect the true intention of the parties, or from the registration of the alleged fraudulent document with the assessor's office for the purpose of transferring the tax declaration (Asuncion vs. Court of Appeals, 150 SCRA 353 [1587]; Bael vs. Intermediate Appellate Court, 169 SCRA 617 [1989].), or from the time the document was registered in the office of the register of deeds, for the familiar rule is that registration is a notice to the whole world. (Armentia vs. Patriarca,

18 SCRA 1253 [1966]; see Metropolitan Waterworks & Sewerage System vs. Court of Appeals, 297 SCRA 287 [1998]; Bentulan vs. Bentulan-Mercado, 446 SCRA 150 [2004].)

Thus, in an action for reconveyance of real property resulting from fraud employed by the defendant who was issued original certificate of title through free patent grants, such discovery is deemed to have taken place from such issuance for the registration of said patent constitutes constructive notice to the whole world. (Balbin vs. Medalla, 108 SCRA 666 [1981]; Hong Kong & Shanghai Banking Corp. vs. Pauli, 161 SCRA 634 [1988].)

Where the action for the annulment of a contract of sale is based not only on fraud in securing the signature of the vendor in said deed, but also on lack of consideration given at the time of the transaction, such action seeks a judicial declaration that the deed of sale is void *ab initio*, which action is imprescriptible. (Castillo vs. Galvan, 85 SCRA 526 [1978].)

**ART. 1392. Ratification extinguishes the action to annul a voidable contract. (1309a)**

### Meaning and effect of ratification.

(1) *Ratification* means that one under no disability voluntarily adopts and gives sanction to some defective or unauthorized contract, act, or proceeding which, without his subsequent sanction or consent, would not be binding or him. It is this voluntary choice, knowingly made, which amounts to a ratification of what was theretofore unauthorized and becomes the authorized act of the party so making the ratification. (see Maglucot-Aw vs. Maglucot, 329 SCRA 78 [2000]; Coronel vs. Constantino, 397 SCRA 128 [2003].)

(2) Ratification cleanses the contract from all its defects from the moment it was constituted. (Art. 1396.) The contract thus becomes valid. (Art. 1390.) Hence, the action to annul is extinguished. (Art. 1392; Tan Ah Chan vs. Gonzalez, 52 Phil. 180 [1928].)

**ART. 1393. Ratification may be effected expressly or tacitly. It is understood that there is a tacit ratification if, with knowledge of the reason which renders the contract voidable and such reason having ceased, the person who has a right to invoke it should execute an act which necessarily implies an intention to waive his right. (1311a)**

**Kinds of ratification.**

They are:

(1) *Express.* — when the ratification is manifested in words or in writing; or

(2) *Implied or tacit.* — It may take diverse forms, such as by silence or acquiescence; by acts showing adoption or approval of the contract; or by acceptance and retention of benefits flowing therefrom. (Acuna vs. Batac Producers Cooperative Marketing Assoc., Inc., 20 SCRA 526 [1967]; see Cadano vs. Cadano, 49 SCRA 33 [1973].) A seller of property cannot negotiate for an increase in the price in one breath and in the same breath contend that the contract of sale is void. (Francisco vs. Herrera, 392 SCRA 317 [2002].)

**Requisites of ratification.**

(1) The requisites for *implied ratification* are the following:

(a) There must be knowledge of the reason which renders the contract voidable;

(b) Such reason must have ceased; and

(c) The injured party must have executed an act which necessarily implies an intention to waive his right.

EXAMPLES:

(1) S, a minor, sold his land to B. Upon reaching the age of majority, S, with full knowledge of his rights in the premises, instead of repudiating the contract, disposed of the greater part of the proceeds, or collected the unpaid balance of the purchase price from B.

In this case, there is tacit ratification by S. (see Uy Soo Lim vs. Tan Unchuan, 38 Phil. 552 [1918].)

(2) In an action for annulment of a contract of sale, S alleged that the sale was executed by him through the threat and intimidation of B. It appears, however, that S deposited the check for the purchase price and withdrew the money from time to time.

The contract is deemed ratified. (see Liboro vs. Rogers, 106 Phil. 404 [1959].)

(2) The requisites for *express ratification* are the same as those for implied ratification except that the former is effected expressly.

### Confirmation, ratification, and recognition or acknowledgment.

Under the old Civil Code, there was a distinction between confirmation and ratification.

The first was the term used to refer to the act by which a person entitled to bring an action for annulment validates a voidable contract, either expressly or impliedly, while the second, to the act by which an unauthorized contract is approved by the person in whose name it was entered into. Recognition, on the other hand, refers to an act whereby a defect of proof is remedied, such as when an oral contract falling under the Statute of Frauds is put in writing.

As was said in a case:

> "*Confirmation* tends to cure a vice of nullity, and *ratification* is for the purpose of giving authority to a person who previously acted in the name of another without authority." *Recognition,* on the other hand, is merely to cure a defect of proof. In recognition, there is no vice to be remedied such as fraud, violence, or mistake, so the case is distinguished from confirmation. In recognition, the person acting in behalf of another is duly authorized to do so, so the situation is different from ratification." (Luna vs. Linatoc, 74 Phil. 15 [1942].)

Under the present Code, there is no more distinction between confirmation and ratification, the latter being also the term used for the former.

**ART. 1394. Ratification may be effected by the guardian of the incapacitated person. (n)**

### Party who may ratify.

(1) A contract entered into by an incapacitated person may be ratified by:

(a) the guardian; or

(b) the injured party himself, provided, he is already capacitated.

As legal representatives of their wards, guardians have the power to contract on their behalf. Hence, they may also ratify contracts entered into by their wards. (see Art. 1407.)

(2) In case the contract is voidable on the ground of mistake, etc., ratification can be made by the party whose consent is vitiated.

**ART. 1395. Ratification does not require the conformity of the contracting party who has no right to bring the action for annulment. (1312)**

### Conformity of guilty party to ratification not required.

Ratification is a unilateral act by which a party waives the defect in his consent. The consent of the guilty party is not required; otherwise, he can conveniently disregard his contract by the simple expedient of refusing to give his conformity.

**ART. 1396. Ratification cleanses the contract from all its defects from the moment it was constituted. (1313)**

### Effect of ratification retroactive.

Ratification purges the contract of all its defects (Art. 1390.) from the moment it was executed. It extinguishes the action to annul. (Art. 1392.) In other words, the effect of ratification is to make the contract valid from its inception subject to the prior rights of third persons.

EXAMPLES:

(1) B forced S to sell the latter's horse. Later, the horse gave birth to a colt. If S should ratify the contract after the birth of the colt, who is entitled to the colt? B, because ratification has a retroactive effect. It validates the contract from the date of its execution.

(2) In a state of drunkenness, S sold a parcel of land to B. Later, S sold the same land to C. The subsequent ratification by S of the sale to B cannot prejudice C.

ILLUSTRATIVE CASES:

1. *Seller was not yet the owner of the property at the time it was sold but the owner, after the sale, acknowledged by means of an affidavit the seller's title.*

*Facts:* As security for his debt, D mortgaged his land in favor of C, under which D promised to assign to C the property if the debt is not paid at maturity. D failed to pay, and C, thinking that he had already owned that property and before any actual assignment was made by D, sold the land to B.

Subsequently, D, made an affidavit in which he acknowledged that title to, and possession of, the aforesaid land had been transferred in a real and absolute sale to C.

*Issue:* May the sale to B be annulled on the ground that C was not yet the owner of the property in question?

*Held:* No. The sale was defective because it was made before D should have transferred the property to C, pursuant to the stipulation. The sale, however, was not void *per se.* Its defect which would have been a ground for annulment, was cured by the act of D in making the affidavit. This confirmation[3] gave full effect to the transfer. *(Dalay vs. Aquiatin, 47 Phil. 951 [1951].)*

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2. *Wife subsequently gave her approval to the extension of the period for repurchase of conjugal property sold under pacto de retro by the husband without her consent.*

*Facts:* A *pacto de retro* sale of conjugal real property was effected by H (husband) without the consent of W (wife). It appears that on the occasion of the extension of the period for repurchase, W gave her approval and conformity to the extension by signing the annotation on the margin of the deed of sale.

*Issue:* What is the effect of this act of W?

*Held:* The act, in effect, constituted implied ratification of the sale, which ratification validated the act of H from the moment of the execution of said contract. In short, such ratification had the effect of purging the contract of any defect which it might have had from the moment of its execution. *(Lanuza vs. De Leon, 20 SCRA 369 [1967].)*

**ART. 1397. The action for the annulment of contracts may be instituted by all who are thereby obliged principally or subsidiarily. However, persons who are capable cannot allege the incapacity of those with whom they contracted; nor can those who exerted intimidation, violence, or undue influence, or employed fraud, or caused mistake base their action upon these flaws of the contract. (1302a)**

[3]There is no more distinction between confirmation and ratification in the present Civil Code. *(supra.)*

**Party entitled to bring an action to annul.**

Two different requisites are required to confer the necessary capacity to bring an action for annulment of a contract, to wit:

(1) The plaintiff must have an interest (see Art. 1311.) in the contract; and

(2) The victim and not the guilty party or the party responsible for the defect is the person who must assert the same. (8 Manresa 801; Wolfson vs. Estate of Martinez, 20 Phil. 340 [1911].)

In an action for the annulment of contracts, the real parties in interest[4] (see Rules of Court, Rule 3, Sec. 2.) are those who are parties to the contract, or are bound either principally or subsidiarily, or are prejudiced in their rights with respect to one of the contracting parties and can show the detriment which would positively result to them from the contract even though they did not intervene in it, or who claim a right to take part in a public bidding but have been illegally excluded from it. (Kilosbayan, Inc. vs. Morato, 246 SCRA 540 [1995].)

The guilty party, including his successors-in-interest, cannot ask for annulment. This rule is sustained by the principle that he who comes to court must do so with clean hands. Thus, a person who employed fraud cannot base his action for annulment of a contract upon such flaw of the contract.

ILLUSTRATIVE CASE:

*Right of a party who has capacity to contract to invoke the incapacity of the contracting party as a defense against performance.*

*Facts:* R (owner) leased his factory to E (lessee) for two years, giving the latter an option to buy the said factory within the same period. R changed his mind and objected to the exercise of the option given to E contending that the option has no valid effect because, being a Spanish citizen, E has no right to buy the factory under the Constitution.

*Issue:* Is this contention of R tenable?

[4] A *real party-in-interest* is one who stands to be benefited or injured by the judgment in the suit, or the party entitled to the avails of the suit. By *real interest* is meant a present substantial interest, as distinguished from a mere expectancy, or a future, contingent, subordinate, or consequential interest. (Pioneer Insurance & Surety Corp. vs. Court of Appeals, 175 SCRA 668 [1989].)

*Held:* No. "To dispute it now on the technical ground that E, being a Spanish citizen, cannot be given that option, is more unfair considering the time and effort he has spent in the transaction. There is no doubt that this objection is but a mere afterthought motivated by R's desire to retain the factory considering its future and the handsome improvements made thereon by P (E's partner).

This R cannot do. There are certain legal and moral considerations that stand on his way. He is barred from doing so not only by the rule of equity which requires that whoever goes to court must do so with clean hands but by the well-known rule of law that he who has capacity to contract may not invoke the incapacity of the party with whom he contracted as a defense against performance." *(Bastida and Ysmael & Co., Inc. vs. Dy Buncio & Co., Inc., 93 Phil. 195 [1953].)*

**Right of successors-in-interest to bring action.**

The successors-in-interest of a party to a voidable contract may sue for the annulment of the contract. (Descutido vs. Baltazar, 1 SCRA 1174 [1961].)

The testamentary or legal heir continues in law as the juridical personality of his predecessor in interest, who transmits to him from the moment of his death such of his rights, actions and obligations as are not extinguished thereby. Hence, he can bring an action to annul a contract entered into by his predecessor in interest in representation of the latter. But one (*i.e.*, nephew or niece) who is not alleged to be a compulsory or forced heir of the deceased who, therefore, could dispose of his estate without further limitations than those established by law, has no legal capacity to challenge the validity of deeds of sale executed by the latter to which the former was not a party as he is not principally or subsidiarily bound thereby. (Velarde vs. Paez, 101 Phil. 376 [1957].)

**Right of strangers to bring action.**

(1) *Persons without material interest in contract.* — One who is not a party to the contract or an assignee thereunder, or does not represent those who took part therein, has, under Article 1397 (and Art. 1311.), no legal capacity to challenge the validity of such contract. (Concepcion vs. Sta. Ana, 87 Phil. 787 [1950].)

He must first have an interest in the contract. "Interest," within the meaning of the term, means material interest, an interest to be affected

by the contract, as distinguished from mere incidental interest. Hence, a person (*e.g.*, lessee of a land) who is not a party to a contract (sale of land by lessor) and for whose benefit it was not expressly made, cannot maintain an action on the contract even if said contract if performed by the parties thereto (seller and buyer) would incidentally affect him. (Allied Banking Corp. vs. Court of Appeals, 284 SCRA 357 [1998].)

(2) *Creditors of victim or aggrieved party.* — Strangers, therefore, even the creditors of the victim or aggrieved party, are without right or personality to bring the action for they are not obliged by the contract, principally or subsidiarily, unless they are prejudiced in their rights with respect to one of the contracting parties, and can show detriment which would positively result to them from the contract in which they had no intervention. (see Santos vs. City of Manila & Arellano University, 45 SCRA 409 [1972]; Singsong vs. Isabela Sawmill, 88 SCRA 623 [1979]; Development Bank of the Phil. vs. Court of Appeals, 96 SCRA 342 [1980]; Malabanan vs. Gaw Ching, 181 SCRA 84 [1990]; Earth Minerals Corporation, Inc. vs. Macaraeg, Jr., 194 SCRA 1 [1991]; Allied Banking Corp. vs. Court of Appeals, *supra*.) Thus, the creditors of the aggrieved party may bring an action for rescission of the contract if the latter has no other property. (see Art. 1381[3].)

(3) *Plaintiffs in a representative suit.* — The rule in Article 1397 that only those who are obliged by the contract, principally or subsidiarily, may institute an action for its annulment was held not applicable to a case where the councilors of practically the entire City Council filed a complaint as a representative suit on behalf and for the benefit of the city to declare null and void a contract executed by the City Mayor without legal authority. (see City Council of Cebu City vs. Cuizon, 47 SCRA 325 [1972].)

EXAMPLES:

(1) S sold to B a parcel of land. The consent of S was vitiated by fraud. (see Art. 1390[2].) Subsequently, S sold the same lot to C.

In this case, C can bring an action to annul the sale to B.

(2) S sold a piece of urban land to B. On grounds provided by law, S or B can bring an action to annul the contract.

But C, an adjoining owner of S, cannot ask for the annulment of the sale as C is not obliged principally nor subsidiarily under the contract.

However, C may question the sale if under the law (Art. 1622.[5]) he has a right of redemption, *i.e.*, the right to repurchase the property from B. In this case, C would be prejudiced, if the sale is not set aside.

*Note:* The exercise of the right of redemption by C will in effect annul the contract of sale between S and B.

ILLUSTRATIVE CASES:

1. *Right of owner of property forfeited and sold at public auction by the government to question sale thereof by the government where seizure case is still pending.*

*Facts:* Using licenses approved by the Office of the President after the expiration of the Import Control Law (R.A. No. 650.), X imported hogsheads of Virginia leaf tobacco. In the seizure proceedings instituted by the Collector of Customs, X was declared in default and the tobacco was declared forfeited to the government.

Later, the shipment was sold at public auction to CTIP. X seeks the annulment of the sale.

*Issue:* Does X have the legal personality to question the legality of the sale?

*Held:* Yes. Even if X had lost all his rights to the tobacco shipment after the same had been seized and forfeited, such loss of right was still subject to a contingency — that is, "at least while the order of seizure has not been set aside." The law expressly gives to any person aggrieved by the decision or action of the Collector of Customs in any case of seizure, the right to have the decision reviewed by the Commissioner of Customs (Sec. 2313, Tariff and Customs Code.); and from the decision of the latter, he has a right to appeal to the Court of Tax Appeals (Sec. 2402, *Ibid.*), and from the latter's decision (to the Court of Appeals, and then) to the Supreme Court.

Neither can it be said that X has no right to have the contract of sale to CTIP annulled, on the ground that he was not a party bound either

[5]Art. 1622. Whenever a piece of urban land which is so small and so situated that a major portion thereof cannot be used for any practical purpose within a reasonable time, having been bought merely for speculation, is about to be resold, the owner of any adjoining land has a right of pre-emption at a reasonable price.

If the re-sale has been perfected, the owner of the adjoining land shall have a right of redemption, also at a reasonable price.

When two or more owners of adjoining lands wish to exercise the rights of pre-emption or redemption, the owner whose intended use of the land in question appears best justified shall be preferred. (n)

principally or subsidiarily by the contract. X seeks the declaration of the nullity of the sale not as a party thereto, but because he had an interest that was affected by the sale. It would be stating the obvious that in the instant case X will suffer detriment as a consequence of the sale, in case it is not set aside. *(Auyong Hian vs. Court of Appeals, 59 SCRA 110 [1974].)*

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2. *Right of actual occupant of a lot to question the sale thereof to another person where the sale appears to have been made in violation of a policy adopted by the seller-government corporation giving preference to qualified actual occupants.*

*Facts:* X has been continuously occupying a lot in an estate belonging to PHHC (a government instrumentality) for 11 years from 1950 to 1961. In a Resolution of the Board of Directors of PHHC adopted in 1951, the said estate was converted into a subdivision for distribution and sale to actual occupants thereof.

In 1961, PHHC sold the same lot to Y. X seeks the declaration of the nullity of the sale.

*Issue:* Has X the right to bring an action for the annulment of the contract of sale in favor of Y?

*Held:* Yes, although he is not obliged principally or subsidiarily under the deed, because she has an interest that is affected by the deed. X was found, after due investigation by the PHHC, the actual occupant of said lot and qualified to acquire the same under its rules and regulations. As a matter of fact, the Chief of its Sales Division recommended that the lot be awarded to X.

The sale to Y is in violation of the policy adopted by the PHHC embodied in its Resolution to give "first chance" in purchasing its lots to qualified actual occupants therein. (*Teves vs. People's Homesite and Housing Corp., 23 SCRA 1141 [1968];* see Lodovica vs. Court of Appeals, 65 SCRA 154 [1975].)

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3. *Right of partnership creditors to question contracts prejudicial to their rights entered into by the remaining partners with a partner who has withdrawn from the partnership.*

*Facts:* After withdrawing from partnership X, A agreed to let B and C, remaining partners, continue the business of the firm. To secure the performance of their obligations, B and C executed a chattel mortgage on certain properties of the partnership in favor of A.

In the meantime, D, etc. extended credit in good faith to the partnership.

*Issue:* Have D, etc. the right to bring an action to annul the chattel mortgage?

*Held: Y*es. D, etc. were prejudiced in their rights by the execution of the chattel mortgage over the properties of the partnership in favor of A by B and C. The withdrawal of A from the partnership was not published in newspapers. Under the law (see Art. 1834.), D, etc. and the general public had a right to expect that whatever credit they extended to B and C doing the business in the name of partnership X could be enforced against the properties of said partnership. *(Singsong vs. Isabela Sawmill, 88 SCRA 623 [1979].)*

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4. *Right of occupant of a lot to question the sale thereof by the owner to another person.*

*Facts:* X occupied a parcel of land owned by PHHC. Notwithstanding his occupancy which was a matter of record with the PHHC in connection with a census of occupants and squatters taken by it, the lot was awarded to Y. Subsequently, Y assigned his right to Z, which transfer was approved by PHHC.

*Issue:* Does X have the legal personality to seek the annulment of PHHC's contract with Y?

*Held:* No. X was a trespasser or squatter. As such, he can have no possessory rights whatever, and his occupancy of the land is only at the PHHC's sufferance, his acts are merely tolerated, and cannot affect PHHC's possession as owner. The squatter is necessarily bound to an implied promise that he will vacate upon demand. He is bereft of any rights which could have been impaired by the award to Y. (*Banez vs. Court of Appeals, 59 SCRA 15 [1974];* see Astudillo vs. Board of Directors of PHHC, 73 SCRA 15 [1976].)

*Note:* At the time the lot was awarded to B, and the transfer to Z was approved, it was not yet the policy of Y PHHC to recognize mere occupancy of a lot as giving a right to purchase the same, for said policy was adopted only later, *i.e.*, on June 27, 1963.

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5. *Right of mortgagee to question the transfer by mortgagor of his right of redemption.*

*Facts*: D, mortgagor, transferred his right to redeem an extra-judicially foreclosed property to B. C, the mortgagee-purchaser, questions the redemption made by B, claiming that the assignment of the right to redeem was simulated and fictitious.

*Issue:* Has C a cause of action to challenge the transfer by D of his right to redeem to B?

*Held:* No. Even assuming that the transfer was fictitious, the same could not affect the mortgagee nor cause him any damage. It matters not to him that the transfer was or was not fraudulently executed. *(Gorospe vs. Santos, 69 SCRA 191 [1976].)*

**ART. 1398. An obligation having been annulled, the contracting parties shall restore to each other the things which have been the subject matter of the contract, with their fruits, and the price with its interest, except in cases provided by law.**

**In obligations to render service, the value thereof shall be the basis for damages. (1303a)**

## Duty of mutual restitution upon annulment.

(1) If the contract is annulled, the parties, as a general rule, must restore to each other (a) the subject matter of the contract with its fruits (see Art. 544, *et seq*.) and (b) the price thereof with legal interest. Like in rescission (see Art. 1385.), the purpose of the law is to restore the parties to their original situation by mutual restitution. The fruits must be returned because the party who received them had no right to enjoy the same. Legal interest must be paid because the party who received the money had no right to use it.

(2) A contract which the law denounces as void is necessarily no contract whatever. The parties and subject matter of the contract remain in all particulars just as they did before any act was performed in relation thereto. The rule is that if a contract is declared a nullity and both parties have no fault or are not guilty, the restoration of was given by each of them to the other is in order. (Development Bank of the Phils. vs. Court of Appeals, 249 SCRA 331 [1995].)

(3) The right of a minor to rescind, upon attaining his majority, a contract entered into during his minority is subject to the conditions (a) that the election to rescind must be made within a reasonable time after attaining majority and (b) that all of the consideration which was in the minor's possession upon his reaching majority must be returned. The disposal of any part of the consideration after the attainment of majority imports an affirmance or ratification of the contract. (Uy Soo Lim vs. Tan Unchuan, 38 Phil. 552 [1918].)

(4) If there has been no performance yet by both contracting parties, it is obvious that there is no duty of mutual restitution.

(5) In personal obligations, where the service had already been rendered, the value thereof with the corresponding interest, is the basis for damages (par. 2.) recoverable from the party benefited by the service.

(6) The effects of an annulment operate prospectively and do not, as a rule, retroact to the time the sale was made. Thus, where S sold to B shares of stock but for one reason or another, the corporate secretary of the corporation failed to record the transfer in the corporate books, and S later sold the same shares of stock to C, even if the sale to C were to be annulled later on, C had in the meantime, title over the shares from the time the sale was perfected until the time such sale is annulled. (see Lim Tay vs. Court of Appeals, 293 SCRA 634 [1998].)

**ART. 1399. When the defect of the contract consists in the incapacity of one of the parties, the incapacitated person is not obliged to make any restitution except insofar as he has been benefited by the thing or price received by him. (1304)**

### Restitution by incapacitated person.

This provision is an exception to the general rule of mutual restitution under the preceding article. The incapacitated person is obliged to make restitution only to the extent that he was benefited by the thing or price received by him. It results, therefore, that if he was not benefited, he is not obliged to restore what he had received but the other contracting party is still bound to return what he had received, whether he was benefited or not.

It is not necessary for the minor to be considered benefited that he invested the thing or amount received. It is sufficient if he has kept it. (see Art. 1241, par. 1.)

The party who has capacity has the burden of proving the benefit or profit received by the incapacitated person. Enrichment of the incapacitated party is not presumed.

An exception to the rule of mutual restitution is also provided in Article 1427. *(infra.)*

**ART. 1400. Whenever the person obliged by the decree of annulment to return the thing can not do so because it has been lost through his fault, he shall return the fruits received and the value of the thing at the time of the loss, with interest from the same date. (1307a)**

### Effect of loss of thing to be returned.

(1) If the thing to be returned is lost without the fault of the person obliged to make restitution (defendant), there is no more obligation to return such thing. But in such a case, the other cannot be compelled to restore what in virtue of the decree of annulment he is bound to return. (Art. 1402.)

(2) If it is lost through his fault, his obligation is not extinguished but is converted into an indemnity for damages consisting of the value of the thing at the time of the loss with interest from the same date and the fruits received from the time the thing was given to him to the time of its loss.

EXAMPLE:

S sold his plow carabao to B. On the petition of S, the contract was annulled by the court. But the carabao died in the possession of B through his fault.

Under Article 1400, B must pay the value of the carabao at the time of its death, with interest from the same date. If the carabao had given birth, the young must also be delivered as the fruit of the said animal.

**ART. 1401. The action for annulment of contracts shall be extinguished when the thing which is the object thereof is lost through the fraud or fault of the person who has a right to institute the proceedings.**

**If the right of action is based upon the incapacity of any one of the contracting parties, the loss of the thing shall not be an obstacle to the success of the action, unless said loss took place through the fraud or fault of the plaintiff. (1314a)**

### Extinguishment of action for annulment.

(1) If the person, who has a right to institute an action for annulment (Art. 1397.), will not be able to restore the thing which he may be obliged to return in case the contract is annulled because such thing is lost through his fraud or fault, his right to have the contract annulled is extinguished. If the loss is not due to his fault or fraud, Article 1402 applies.

The action for annulment shall be extinguished only if the loss is through the fault or fraud of the plaintiff.

(2) Under the second paragraph, the right of action is based upon the incapacity of any one of the contracting parties. Whether the right of action is based upon incapacity or not, the rule is the same. It is no longer necessary that the fraud or fault on the part of the plaintiff (the incapacitated person) resulting in the loss must have occurred "after having acquired capacity" as under the old Code. This qualification has been deleted in the present article. The deletion has made the second paragraph redundant.

**ART. 1402. As long as one of the contracting parties does not restore what in virtue of the decree of annulment he is bound to return, the other cannot be compelled to comply with what is incumbent upon him. (1308)**

### Effect where a party cannot restore what he is bound to return.

When a contract is annulled, a reciprocal obligation of restitution is created. The return by one party of what he is obliged to restore by the decree of annulment may be regarded as a condition to the fulfillment by the other of what is incumbent upon him. (see Art. 1191.) In effect, there will be no annulment if the party cannot restore what he is bound to return. This is true even if the loss is due to a fortuitous event. (see comments under Art. 1400.)

However, if the party who lost the thing through a fortuitous event offers to pay its value with the fruits received if any (there is no liability to pay interest since the loss is without his fault), the other can be required to make restitution.

EXAMPLE:

B forced S to sell the latter's horse. The contract was annulled by the court at the instance of S.

If the horse died through the fault of B, Article 1400 governs. If the horse died due to a fortuitous event, S can refuse to return the purchase price. But if B offers to pay the value of the horse (with its fruits if any) at the time of its death, he can compel S to return the price with the interest. With or without the fault of B, S, as injured party, has the right to demand the value of the horse. (see Dumasug vs. Modelo, 34 Phil. 252 [1916].)

ILLUSTRATIVE CASE:

*Nature of possession of a buyer of property who knew that the sale thereof to him was in violation of law.*

*Facts:* L, a lawyer, purchased the land of his client which was then the subject of a litigation. In an action to annul the sale for being in violation of Article 1491[6] which prohibits lawyers from acquiring property or rights involved in any litigation in which they may take part by virtue of their profession, L claimed the right to the reimbursement of the purchase price as well as the land taxes and value of the improvements constructed by him on said land.

*Issue:* Is Article 1402 applicable?

*Held:* No. Being a lawyer who is presumed to know the law, L must, therefore, from the very beginning, have been well aware of the defect in his title and is consequently a possessor in bad faith. In cases of ejectment, only the possessor in good faith, may retain the land until the necessary expenses have been refunded. (Art. 546.) L has been a possessor in bad faith for many years and is bound to account for the fruits received and for those which the lawful possessor might have received. (Art. 549.) The probability is that the fruits are much more than equivalent to the expenditures made by L.

Furthermore, under the circumstances of the case, it is difficult to believe that L never paid any part of the purchase price, and there is room for more than a suspicion that the deed was purely fictitious. Also, L has made no offers to indemnify the appellees for the fruits received by him from the land in question. *(Director of Lands vs. Abragat, 53 Phil. 147 [1929].)*

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[6]See Note 1, under Article 1327.

# Chapter 8

# UNENFORCEABLE CONTRACTS (n)

**ART. 1403. The following contracts are unenforceable, unless they are ratified:**

**(1) Those entered into the name of another person by one who has been given no authority or legal representation, or who has acted beyond his powers;**

**(2) Those that do not comply with the Statute of Frauds as set forth in this number. In the following cases an agreement hereafter made shall be unenforceable by action, unless the same, or some note or memorandum thereof, be in writing, and subscribed by the party charged, or by his agent; evidence, therefore, of the agreement cannot be received without the writing, or a secondary evidence of its contents:**

**(a) An agreement that by its terms is not to be performed within a year from the making thereof;**

**(b) A special promise to answer for the debt, default, or miscarriage of another;**

**(c) An agreement made in consideration of marriage, other than a mutual promise to marry;**

**(d) An agreement for the sale of goods, chattels, or things in action, at a price not less than Five hundred pesos, unless the buyer accept and receive part of such goods and chattels, or the evidences, or some of them, of such things in action, or pay at the time some part of the purchase money; but when a sale is made by auction and entry is made by the auctioneer in his sales book, at the time of the sale, of the amount and kind of property sold, terms of sale, price, names of the purchasers and person on whose account the sale is made, it is a sufficient memorandum;**

**(e) An agreement for the leasing for a longer period than one year, or for the sale of real property or of an interest therein;**

**(f) A representation as to the credit of a third person.**

**(3) Those where both parties are incapable of giving consent to a contract.**

### Meaning of unenforceable contracts.

*Unenforceable contracts* are those that cannot be enforced in court or sued upon by reason of defects provided by law until and unless they are ratified according to law.

### Binding force of unenforceable contracts.

While rescissible and voidable contracts are valid and enforceable unless they are rescinded or annulled, unenforceable contracts, although valid, are unenforceable unless they are ratified.

The mere lapse of time cannot give effect to such a contract. The defect is of a permanent nature and will exist as long as the unenforceable contract is not duly ratified by the person in whose name the contract was executed.

### Kinds of unenforceable contracts.

Under Article 1403, the following contracts are unenforceable:

(1) Those entered into in the name of another by one without or acting in excess of authority;

(2) Those that do not comply with the Statute of Frauds; and

(3) Those where both parties are incapable of giving consent.

A party to an unenforceable contract may bring an action to enforce it subject to the defense of the lack of the required form (Statute of Frauds) or absence of authority or in excess thereof. The law expressly provides that such a contract cannot be assailed by a third person. (Art. 1408.)

### Meaning of unauthorized contracts.

*Unauthorized contracts* are those entered into in the name of another person by one who has been given no authority or legal representation or who has acted beyond his powers.

They are governed by Article 1317 and the principles of agency. (Art. 1404; see Arts. 1868, 1869, 1881, 1882, 1883, 1900, 1901.)

**Statute of Frauds.**

The term "statute of frauds" is descriptive of statutes which require certain classes of contracts to be in writing. This statute does not deprive the parties of the right to contract with respect to the matters therein involved, but merely regulates the formalities of the contract necessary to render it enforceable. The effect of non-compliance is simply that no action can proved unless the requirement is complied with.

Thus, they are included in the provisions of the New Civil Code regarding unenforceable contracts, more particularly Art. 1403(2). (Rosencor Development vs. Inquing, 354 SCRA 119 [2001]; Litonjua vs. Fernandez, 427 SCRA 478 [2004]; Torcuator vs. Bernabe, 459 SCRA 439 SCRA [2005]; Peñalber vs. Ramos, 577 SCRA 509 [2009].) Evidence of the agreement cannot be received without the writing or a secondary evidence of its contents. (Swedish Match, AB vs. Court of Appeals, 441 SCRA 1 [2004].)

(1) *History.* — In 1677, the English Parliament enacted a statute to counter the evil practice of giving false testimony in actions founded on certain kinds of contracts. It attempted to deal with the prevalence of successful perjury by making specified contracts unenforceable unless evidenced in a prescribed manner — in general, by a written memorandum signed by the party against whom liability under the contract was sought to be enforced. (Babb & Martin, Business Law, *op. cit.*, p. 27.) Since then, the statute has been called "Statute of Frauds." It has been adopted, in more or less modified form, in the Philippines. (see Phil. Nat. Bank vs. Phil. Vegetable Oil Co., 49 Phil. 857 [1927].)

Our Statute of Frauds was originally taken from the Code of Civil Procedure of the State of California. The Statute was introduced in the Philippines by Section 335 of Act No. 190 (Code of Civil Procedure) and subsequently embodied *in toto* in the old Rules of Court under Evidence as Section 21, Rule 123. (Barcelona vs. Barcelona, 100 Phil. 251 [1956].) It is now embodied with slight modifications in Article 1403(2) of the new Civil Code under the title "Unenforceable Contracts." According to the Supreme Court, the transfer was not only a matter of style but to show that the statute of frauds is also a substantive law. (Claudel vs. Court of Appeals, 199 SCRA 113 [1991].)

(2) *Purpose.* — The Statute of Frauds has been enacted not only to prevent fraud and perjury in the enforcement of obligations depending for their evidence on the unassisted memory of witness but also to guard against the mistakes of honest men by requiring that certain agreements specified (Art. 1403, No. 2[a-f].) must be in writing signed by the party to be charged; otherwise, they are unenforceable by action in court. (see Shoemaker vs. La Tondeña, Inc., 68 Phil. 24 [1939]; Rosencor Development Corporation vs. Inquing, *supra*.) Unless they be in writing, there may be no palpable evidence of the intention of the contracting parties and the court must perforce rely upon no other evidence than the mere recollection or memory of witnesses, which in many times faulty and unreliable. (see Facturan vs. Sabanal, 81 Phil. 513 [1948].) Thus, by requiring that such agreements can only be proved by a writing, the object is effectually attained since the writing becomes its own interpreter.

Since the Statute of Frauds was enacted for the purpose of preventing frauds, it should not be made the instrument to further them. (Phil. National Bank vs. Phil. Vegetable Oil Co., *supra*; Cuyugan vs. Santos, 34 Phil. 100 [1916].) Thus, where a party has entirely complied with his obligations under an oral contract, the other cannot avoid the fulfillment of those incumbent upon him under the same contract by invoking the Statute of Frauds. Equity demands that oral evidence be admitted to prove the contract because the statute aims to prevent and not to protect fraud. (Shoemaker vs. La Tondeña, *supra*.)

(3) *Application.* — Some fundamental principles relative to the Statute of Frauds are given hereunder:

(a) The application of the Statute of Frauds presupposes the existence of a perfected contract and requires only a note or memorandum be executed in order to compel judicial enforcement thereof. Where there is no perfected contract, there is no basis for the application of the statute. (Villanueva vs. Court of Appeals, 78 SCAD 484, 267 SCRA 892 [1997]; Firme vs. Bukal Enterprises & Dev. Corp., 414 SCRA 190 [2003].)

(b) The Statute of Frauds refers to specific kinds of transactions and cannot apply to any other transaction that is not enumerated therein.[1] It is not applicable in actions which are neither for

[1]Under Article 1443, "No express trusts concerning an immovable or any interest therein may be proved by parol evidence."

damages because of a violation of a contract, nor for the specific performance thereof. (Facturan vs. Sabanal, 81 Phil. 512 [1948]; Lim vs. Lim, 10 Phil. 635 [1908].) Thus, the purchaser of a parcel of land may prove the oral contract of sale in a subsequent action for ejectment against a third person who is in possession of the property.

An action by a withdrawing party to recover his partial payment of the consideration of an oral contract to sell a building with an oral promise by the other contracting party to assign the contract of lease on the lot where the building is constructed, which contract is unenforceable under the Statue of Frauds, by reason of the failure of the latter to comply with his obligation to execute the deed of sale and assign the contract of lease, is not covered by the Statute. The action is not for specific performance and there is partial execution. (Asia Production Co., Inc. vs. Paño, 205 SCRA 458 [1992].)

A partition among heirs or renunciation of an inheritance by some of them is not covered by the Statute as it is not exactly a conveyance of real property for the reason that it does not involve transfer of property from one to another, but rather a confirmation or ratification of title or right of property by the heir renouncing in favor of another accepting and receiving the inheritance. (Barcelona vs. Barcelona, 100 Phil. 251 [1956].) No law requires partition among the heirs to be in writing and be registered in order to be valid. The partition of inherited property need not be embodied in a public document to be effective as regards the heirs who participated therein. (Pada-Kilario vs. Court of Appeals, 322 SCRA 481 [2000]; Castro vs Miat, 397 SCRA 271 [2003].)

A note or memorandum is not necessary for the enforceability of a contract of partition as it is not one of the contracts mentioned in Article 1403 which enumerates the limited instances when written proof of a contract is essential for enforceability. (Tan vs. Lim, 296 SCRA 455 [1998].)

An agreement creating an easement of right-of-way is not also covered by the Statute since it is not a sale of real property or of an

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Article 1443 requires a writing not for validity of an express trust but for purposes of proof. Hence, this provision may, by analogy, be also included under the Statute of Frauds.

interest therein. (Western Mindanao Lumber Co., Inc. vs. Medalle, 79 SCRA 703 [1977].) Neither is an agreement between adjoining owners as to their estates' boundaries. (Hernandez vs. Court of Appeals, 160 SCRA 821 [1988].)

A right of first refusal is not among those listed as unenforceable under the statute of frauds. Furthermore, such right is not by any means a perfected contract of sale of real property. At best, it is a contractual grant of the right over the property sought to be sold. (Rosencor Development Corporation vs. Inquing, *supra*.)

The Statute of Frauds and the rules of evidence do not require the presentation of receipts in order to prove the existence of a recruitment agreement and the procurement of fees in illegal recruitment cases. The amounts may consequently be proved by the testimony of witnesses. (People vs. Mercado, 304 SCRA 504 [1999].)

(c) It is applicable only to executory contracts (where no performance has as yet been made by both parties) and not to contracts which are totally (consummated) or partially performed.

The reason is that partial performance, like the writing, furnishes reliable evidence of the intention of the parties or the existence of the contract. A contrary rule would result in injustice or unfairness to the party who has performed his obligation (see Art. 1405; see Espiritu vs. CFI of Cavite, 47 SCRA 354 [1972].), for it would enable the other to keep the benefits already derived by him from the transaction, and at the same time evade the obligations assumed or contracted by him thereby. So that when the party concerned has pleaded partial performance, such party is entitled to a reasonable chance to establish by parol evidence the truth of his allegations, as well as the contract itself. The partial performance may be proved by either oral or documentary evidence. (Carbonnel vs. Poncio, 103 Phil. 655 [1988]; also Paterno vs. Jao Yan, 1 SCRA 631 [1961]; Khan vs. Asuncion, 19 SCRA 996 [1991].)

Where the facts alleged in the complaint are constitutive of a consummated contract of sale, oral evidence is not forbidden by the statute and may not be excluded in court. (Inigo vs. Estate of Maloto, 21 SCRA 246 [1967]; Victoriano vs. Court of Appeals, 194 SCRA 19 [1913].)

(d) It is not applicable where the contract is admitted, by the failure to deny specifically its existence, no further evidence thereof being required. (see Hernandez vs. Andal, 78 Phil. 196 [1947]; Almirol vs. Monserrat, 48 Phil. 67 [1925].)

(e) It is not applicable where a writing does not express the true agreement of the parties. This is so because the Statute cannot be used as a shield for fraud or as a means for the perpetration of it. (Cuyugan vs. Santos, 34 Phil. 100 [1916].)

(f) It does not declare that contracts infringing it are void and of no effect but merely unenforceable. (Art. 1403, No. 2, opening clause.) The form required is for evidential purposes only. (see Art. 1405.)

(g) It does not determine the credibility or weight of evidence but merely regulates the admissibility thereof.

(h) The defense of the Statute of Frauds is subject to waiver. (Art. 1405.)

(i) The defense of the Statute of Frauds is personal to the parties and cannot be interposed by strangers to the contract. (Art. 1408.)

ILLUSTRATIVE CASES:

1. *Verbal contract of sale of land is adduced to show the lawful possession of applicants entitling them to have their title thereto registered.*

*Facts:* X, etc., presented evidence that they have been in possession of the parcel of land in question since the year 1912 when Y, before his death, delivered to them said land pursuant to a verbal contract of sale for the price of P1,500.00 payable by installments, of which X, etc., had then paid to Y P500.00 and the latter delivered to them the documents pertaining to the land; and that since their possession and before them, that of Y, under a claim of ownership, had been exclusive and continuous, they were entitled to have their title over said parcel of land registered, as applied for in the registration proceeding.

*Issue:* May X, etc., introduce evidence of the alleged verbal contract of sale?

*Held:* Yes. The contract was not covered by the Statute of Frauds because the contract was partially executed. Furthermore, the verbal contract was adduced not for the purpose of enforcing performance thereof, but as the basis of the lawful possession of the applicants (X,

etc.) entitling them to have the land thereby sold registered in their own names. *(Almirol and Cariño vs. Monserrat, 48 Phil. 67 [1925].)*

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2. *Verbal agreement sought to be enforced refers not to a sale but to a promise to convey real property for services rendered.*

*Facts:* In his complaint, X alleged as a cause of action that in 1952 the defendants availed themselves of his services as an intermediary with the Deudors to work for the amicable settlement of a civil case and notwithstanding his having performed his services, as in fact a compromise agreement was entered into, the defendants had refused to convey to him the 3,000 square meters of land which the defendants had promised to do within 10 years from the signing of the agreement.

In their motion to dismiss, the defendants alleged that the alleged agreement about X's services was unenforceable under the Statute of Frauds, there being nothing in writing about it. The trial court dismissed the complaint.

*Issue:* Is the Statute of Frauds applicable?

*Held:* No. It is elementary that the Statute refers to specific kinds of transactions and that it cannot apply to any that is not enumerated therein. In the instant case, what X is trying to enforce is the delivery to him of 3,000 square meters of land which he claims defendants promised to do in consideration of his services as mediator or intermediary in effecting a compromise of the civil case between the defendants and the Deudors.

In no sense may such alleged contract be considered as being a "sale of real property or of any interest therein." Indeed, not all dealings involving interest in real property come under the Statute. *(Cruz vs. J.M. Tuazon & Co., Inc. and G. Araneta, Inc., 76 SCRA 543 [1977].)*

### Agreements within the scope of the Statute of Frauds.

(1) *Agreement not to be performed within one year from the making thereof.* — In order that this provision be applicable, it must appear that the parties intended when they made the contract that it should not be performed within a year. In other words, that a contract cannot be performed within a year means not a natural or physical impossibility but an impossibility by the terms of the contract itself or by the understanding and intention of the parties to the contract. A contract is within the Statute if the time for the full performance of the contract exceeds a year, although the excess is ever so little. (49 Am. Jur. 384.)

The broad view is that the Statute applies only to agreements not to be performed on either side within a year from the making thereof. According to this view, agreements to be fully performed on one side within the year are taken out of the operation of the Statute. (Phil. National Bank vs. Phil. Vegetable Oil Co., 49 Phil. 857 [1927]; see Babao vs. Perez, 102 Phil. 757 [1957]; Asturias Sugar Central, Inc. vs. Montinola, 69 Phil. 725 [1940].)

EXAMPLE:

On December 1, 2003, X entered into an oral contract with Y for the construction of Y's house to begin on December 10, 2004. The contract must be in writing to be enforceable.

ILLUSTRATIVE CASE:

*Full performance had not been made by one party within the one year period rule under verbal agreement which is vague and ambiguous.*

*Facts:* During her lifetime, X entered into a verbal agreement whereby Y bound himself to improve a 156-hectare land belonging to X by levelling and clearing all forest trees standing thereon and planting in lieu thereof, coconuts, rice, etc., and to act as administrator of said land, in consideration of which X, in turn, bound herself to give to Y 1/2 of the land together with the improvements upon her death.

After 23 years, not all was cleared and planted but only a portion thereof.

*Issue:* May the agreement be proved by parol evidence?

*Held:* No. (1) The alleged verbal agreement was made in 1924. X died in 1947, while Y died in 1948. The undertaking of Y, by its very nature, could not have been accomplished in one year as in fact it lasted over a period of 23 years.

Contracts which by their terms are not to be performed within one year may be taken out of the Statute through performance by one party thereto. In order, however, that a partial performance may take the case out of the operation of the Statute, it must appear clear that the full performance has been made by one party within one year, as otherwise, the Statute would apply.[2]

(2) The agreement is vague and ambiguous for it does not specify how many hectares are to be planted to coconuts, how many to rice and

[2]The verbal agreement is not covered by the Statute of Frauds and may, therefore, be proved by parol evidence because there was partial performance.

corn, etc. As the alleged contract stands, if Y should plant 1/2 hectares to coconuts, 1/2 to rice, and another 1/2 hectare to corn, and the rest to bananas and bamboo trees, he would be entitled to receive 1/2 of the 156 hectares for his services. That certainly would be unfair and unheard of. On the part of X, her promise was incapable of execution. How could she give and deliver 1/2 of the land upon her death?

Where the parol contract is vague and ambiguous, the doctrine of part performance cannot be invoked to take the case out of the operation of the Statute. Obviously, there can be no part performance until there is a definite and complete agreement between the parties. All the essential terms of the contract must be established by competent proof, and shown to be definite, certain, clear, and unambiguous. *(Babao vs. Perez, supra.)*

A contract, however, does not necessarily come within the ambit of the provision merely because it is continued from year to year for several years. Thus, a contract for domestic and farm services at the rate of P10.00 per month but without a fixed period was held not falling within the terms of the provision, despite the fact that the agreement was continued for about twelve (12) years. (Arroyo vs. Azur, 76 Phil. 493 [1946].) In this case, the contract is no longer executory.

(2) *Promise to answer for the debt, default, or miscarriage of another.* — In a guaranty, the promise is merely subsidiary or collateral to the promise of another (the original or principal debtor). If the promise is an original or an independent one, that is, if the promisor becomes thereby primarily liable for the payment of the debt, the promise is not within the Statute and may be proved by oral evidence.[3]

EXAMPLE:

D owes C P1,000.00 with G as guarantor. Here, G has a special promise to answer for the debt of D in case D fails to pay the same. This promise is unenforceable unless it is in writing signed by G.

If the promise of G is to pay C what D owes him (C), G's promise, even if verbally made, is enforceable as it is not a collateral "promise to answer for the debt, default, or miscarriage of another."

[3]The concept of guarantee is inconsistent with the concept of *letter of credit* defined as an engagement by a bank or other person made at the request of a customer that the issuer shall honor drafts or demands of payment upon compliance with the conditions specified in the credit. It is a primary and direct obligation and not an accessory contract. While it is a security arrangement, the engagement of the issuer is to pay the seller once the draft and other required documents are presented to it. (Metropolitan Waterworks and Sewerage System vs. Daway, 432 SCRA 559 [2004].)

(3) *Agreement in consideration of marriage other than a mutual promise to marry.* — Where the marriage is a mere incident, and not the end to be attained by the agreement, it is not deemed to be the consideration. Where there is some other consideration sufficient to support the oral agreement, in addition to marriage, such agreement is not covered by the Statute and oral evidence is admissible to prove the same. (see 27 C.J. 127.)

EXAMPLE:

X agrees to build a house worth P500,000.00 for Y if Y will marry X. This must appear in writing to be enforceable unless X ratifies the agreement. The Statute applies even when the promise to build the house is made by a third person to Y.

But a mutual promise of X and Y to marry each other need not be in writing. For breach of the mutual promise to marry, the injured party may prove the promise by oral evidence in an action for damages.

The law states no period for performance unlike in the case of the agreement referred to in No. 1. Hence, an oral mutual promise to marry may be proved by parol evidence although the marriage is to be celebrated beyond one (1) year.

*Note: Marriage settlements* (also called *ante-nuptial contracts*) are agreements entered into the future spouses before the celebration of marriage and in consideration thereof, for the purpose of fixing the conditions of their property relations both with respect to their present and future property. (See Arts. 74-76, Family Code.)

*Donations propter nuptias* or *donations by reason of marriage* are those which are made before its celebration, in consideration of the same and in favor of one or both of the future spouses. (Art. 82, *Ibid.*)

Both are agreements made in consideration of marriage and are, therefore, covered by the Statute of Frauds.

ILLUSTRATIVE CASE:

*Agreements entered into involved both an agreement in consideration of marriage and a mutual promise to marry.*

*Facts:* D (daughter of F) and F, on one side, and S (son of G) and G, on the other hand, agreed on the marriage between D and S, provided, that S and G would improve the former's house, spend for the wedding, etc. S and G brought action against D and F to recover damages resulting from

their refusal to carry out their promises. S and G alleged that they made the improvements but D and F refused to carry out the previously agreed marriage. The agreement was not in writing.

*Issue*: May the agreement be proved orally?

*Held:* It depends. In this case, there are actually two agreements. For breach of the mutual promise to marry, S may sue D for damages, even if the promise was orally made. The agreement between G and S and the defendants D and F is in consideration of the marriage between D and S; and being oral, is unenforceable. Evidently, as to G and F, the action cannot be maintained on the theory of "mutual promise to marry."

Neither may it be regarded as action by G against D "on a mutual promise to marry." S may continue his action against D for such damages as may have resulted from her failure to carry out their mutual matrimonial promises. (*Cabague vs. Auxilio, 92 Phil. 295 [1952];* see Hermosisima vs. Court of Appeals, 109 Phil. 629 [1960].)

(4) *Agreement for sale of goods, etc. at price not less than P500.00.* —

EXAMPLES:

(1) X and Y mutually promised to buy and sell a piano at a price of P4,000.00. This contract must be in writing to be enforceable against either party unless there is delivery or partial or full payment, in which case, it is taken out of the operation of the Statute of Frauds and the contract may be enforced even if it was made orally.

(2) If Y denies a contract of sale of goods worth P500.00 but X claims the price is only P450.00 (which is less than P500.00), oral evidence of the sale is admissible inasmuch as the true agreement claimed is not covered by the Statute.

(5) *Agreement for leasing for a longer period than one year.*[4] —

EXAMPLE:

R agreed to lease his house to E for two (2) years. Again, this agreement must appear in writing to be enforceable unless it is partially executed.

[4]An alleged verbal assurance of renewal of a lease is inadmissible to qualify the terms of a written lease agreement under the parol evidence rule and unenforceable under the Statute of Frauds. (Fernandez vs. Court of Appeals, 166 SCRA 577 [1988]; Inter-Asia Services Corp. vs. Court of Appeals, 263 SCRA 408 [1996].)

(6) *Agreement for the sale of real property or of an interest therein.* — No law or jurisprudence prescribes that the contract of sale be put in writing before such contract can validly cede or transmit rights over a certain real property between the parties themselves. However, in the event that a third party disputes the ownership of the property, the person against whom the claim is brought cannot present any proof of sale and, hence, has no means to enforce the contract. Thus, the Statute was precisely devised to protect the parties in a contract of sale of real property so that no such contract is enforceable unless certain requisites, for purposes of proof are met. (Claudel vs. Court of Appeals, 199 SCRA 113 [1991].)

An agreement creating an easement of right of way is not covered by the Statute since it is not a sale of real property or of an interest therein. (Western Mindanao Co. vs. Medalle, 79 SCRA 703 [1977].)

EXAMPLES:

(1) S orally sold his land or his right or usufruct in said land to B. The agreement is also unenforceable, unless it has been partially executed.

(2) S agreed in a private document to sell his land to B. The document was given to B who lost it. May B prove the agreement by oral evidence?

Yes. Here, what is to be proved is not an oral but a written contract of sale. It is necessary, however, that B first presents proof that the written agreement really existed.[5]

(7) *Representation as to the credit of a third person.* —

EXAMPLE:

D is seeking a loan from C. T represents to C that D is solvent and has a good credit reputation. Relying upon this representation, C extends a loan to D who, actually, is insolvent.

The representation of T, which was made to induce the extension of credit to D, must be in writing to be enforceable. Here, there is no

[5]Sec. 5. *When original document is unavailable.* — When the original document has been lost or destroyed, or cannot be produced in court, the offeror, upon proof of its execution or existence and the cause of its unavailability without bad faith on his part, may prove its contents by a copy, or by a recital of its contents in some authentic document, or by the testimony of witnesses in the order stated. (4a) (Rule 130, Rules of Court.)

promise by T to answer for the debt of D. Note that there is no agreement involved.

(8) *Express trusts concerning an immovable or any interest therein.* — Under Article 1443 (see Note 1.), a writing is necessary, not for purposes of validity, but to prove such trusts. An express trust over personal property or any interest therein, and an implied trust, whether involving real or personal property, may be proved by oral evidence. (see Art. 1457.)

**Modes of satisfaction of the Statute.**

The Statute specifies three ways in which a contract of *sale* of goods within its terms may be made binding, namely:

(1) the giving of a note or memorandum;

(2) acceptance and receipt of part of the goods (or things in action) sold; and

(3) payment at the time some part of the purchase price.

For a note or memorandum to satisfy the statute, it must be complete in itself and cannot rest partly in writing and partly in parol, and it must contain the names of the parties, the terms and conditions of the contract, and a description of the property sufficient to render it capable of identification. Also to be binding on the person to be charged, it must be signed by the said party or by his agent duly authorized in writing. (Litonjua vs. Fernandez, 427 SCRA 478 [2004]; Swedish Match, AB vs. Court of Appeals, 441 SCRA 1 [2004].)

The requirement of a memorandum is obviously suitable either for a contract to sell or a sale. The other two modes of satisfaction seem more naturally to apply to sales than to executory contracts.

The Statute of Frauds applies not only to sale of goods but to things in action as well. (see Art. 1402[2, d].) Thus, an assignment of credit more than P500.00 is within the operation of the statute. (see H.S. de Leon, Comments and Cases on Sales and Lease, 2005 Ed., p. 118.)

**Test as to whether promise is original or a collateral one.**

"Just what is the character of a promise as original or collateral is a question of law and fact which must in each case be determined from

the evidence as to the language used in making the promise and the circumstances under which it was made.

Since, as a general rule, the parties making a promise of this nature rarely understand the legal and technical difference between an original and a collateral promise, the precise form of the words is not always conclusive. So that it is said that while, as a matter of law a promise absolute in form, to pay or to be responsible, or to be the paymaster, is an original promise and while on the other hand, if the promisor says, 'I will see you paid,' or 'I will pay if he does not,' or uses equivalent words, the promise standing alone is collateral, yet under all the circumstances of the case, an absolute promise, or a promise to be 'responsible,' may be found to be collateral, or promises deemed *prima facie* collateral may be adjudged original."

Thus, if goods are sold upon the sole credit and responsibility of the party who makes the promise, then even though they be delivered to a third person, there is no liability of the third person to which that of the party promising can be collateral, and consequently, such a promise is not within the Statute of Frauds. (Reiss vs. Memije, 15 Phil. 350 [1910], citing 29 Encyclopedia of Law, 2nd Ed., p. 907 and cases.)

ILLUSTRATIVE CASE:

*Supplier of lumber extended credit to building contractor without commercial standing in the community solely on the promise of owner of house to be repaired to stand good for the purchase price.*

*Facts:* X entered into a contract with Y (contractor) for the repair of a house. Y undertook to furnish the necessary materials. Having no money and no credit, Y was unable to continue the purchase of the necessary lumber from T who refused to sell without payment in advance. X told T he would stand good for the amount of lumber needed in the repair of his house.

T brought action to recover the unpaid balance of the purchase price of lumber delivered.

*Issue:* Was the promise of X unenforceable not being in writing?

*Held:* No. The promise of X was not collateral but an original one and, therefore, did not have to be in writing. The circumstances disclosed that the credit for the lumber was extended by T solely and exclusively to X under a verbal agreement he had with him.

X admitted on the stand that Y had no commercial credit or standing in the community and it appeared that T, after investigation, absolutely

refused to extend Y any credit whatsoever and that X was well aware of the fact and that X examined every invoice which by agreement was submitted to him, and that no lumber was delivered without his approval. (*Reiss vs. Memije, supra;* see Colbert vs. Bachrach, 12 Phil. 83 [1929].)

**Effect of Statute of Frauds where contract divisible/indivisible.**

The enforceability of a contract for the sale of chattels when affected by the Statute of Frauds often depends on whether it is severable or inseverable. (see Art. 1420.) This question may arise in two (2) ways:

*First,* the separate chattels may each sell below P500.00 but the sum total of the price of all the chattels sold may amount to or exceed such limit. In this case, if the sales are separate, each sale for a price below the statutory limit is not affected by the Statute. If, however, the transaction is one entire sale and the price amounts to or exceeds P500.00, the Statute applies, though separate chattels are sold, and though delivery is to be made in installments, and though the price of each chattel is estimated separately.

*Second,* part of one lot of chattels sold may be received and accepted, or they may be paid for in part. Does this satisfy the Statute as to other chattels sold between the same parties? The answer depends on whether the sales amount to one transaction or not. If separate chattels are sold under one contract, any act or receipt and acceptance or part payment which satisfies the Statute as to one chattel, satisfies it as to all. (G. Florendo, *supra,* p. 297, citing Page, The Law of Contracts, Sec. 753.)

Whether a contract is divisible or not depends primarily on the intention of the parties as shown by the terms of the contract and the facts of the particular case. (see Art. 1420.)

EXAMPLES:

S (seller) and B (buyer) entered into an oral contract for the sale of two distinct articles, at separate prices for each: item 1 for P400.00 and item 2 for P500.00.

(1) *Transaction is one entire sale.* — The receipt (or payment) by B of item 1 takes the contract as to item 2 also out of the Statute, and *vice versa.* The rule is the same where the price of item 2 is less than P500.00 but the total consideration amounts to or exceeds P500.00. Of course, the Statute is not applicable if the sum total of the price is below P500.00.

(2) *Sales are separate.* — The contract as to item 1 (for P400.00) is not covered by the Statute. Hence, the receipt by B of item 1 does not satisfy the Statute as to item 2 (for P500.00). If B receives possession of item 2, then both sales may be proved by parol evidence: as to item 1, the Statute does not apply, and as to item 2, the receipt thereof satisfies the Statute as to the same.

If the price for each item is less than P500.00, S cannot interpose the Statute as a defense in an action by B to enforce the sales although the sum total of the price amounts to or exceeds P500.00. In such case, the sales are not within the Statute since they are separate transactions.

**Sufficiency of note or memorandum.**

(1) No particular *form of language or instrument* is necessary to constitute a note or memorandum in writing under the Statute of Frauds. Any document or writing, formal or informal, written either for the purpose of furnishing evidence of the contract or for another purpose, which states all the essential elements of the contract with reasonable certainty, and which is *signed by the party* to be charged or his lawfully authorized agent, is a sufficient note or memorandum in writing sufficient to satisfy the requirements of the statute. A memorandum may be written as well with lead pencil as with pen and ink. It may also be made on a printed form. (see 37 C.J.S. 653-654; Jimenez vs. Rabot, 38 Phil. 378 [1918].)

An exchange of written correspondence between the parties may constitute sufficient writing to evidence the agreement for purposes of complying with the statute of frauds. (City of Cebu vs. Heirs of C. Rubi, 306 SCRA 408 [1999].)

(2) It need not state the *consideration for the contract* since the existence of this element is presumed, unless the debtor proves the contrary. (Art. 1354; see Behn, Meyer & Co. vs. Davis and Gonzales, 37 Phil. 431 [1918].) But it must be subscribed or signed by the party charged or at least by a person who had authority to bind him. (Basa vs. Raquel, 45 Phil. 655 [1923].)

ILLUSTRATIVE CASE:

*Sufficiency of an agent's authority to sell real property where the property is not precisely described.*

*Facts:* S wrote to his sister R to sell one of three parcels of land belonging to the former. R sold one parcel to B but R failed to forward the

proceeds to S. The letter did not describe the parcel to be sold. S brought action to recover the land in question.

*Issue:* Is the letter sufficient to bind S in the sale made to B?

*Held:* Yes. The present case relates to the sufficiency of the authorization to sell[6] not to the sufficiency of the contract or conveyance. The letter which S executed contains a proper description of the property which he purported to convey. The law does not require for the effectiveness of an authority to sell that the property to be sold should be precisely described. It is sufficient if the authority is so expressed as to determine without doubt the limits of the agent's authority.

The purpose of a power of attorney is to substitute the mind and hand of the agent for the mind and hand of the principal; and if the character and extent of the power is so far defined as to leave no doubt as to the limits within which the agent is authorized to act, and he acts within those limits, the principal cannot question the validity of his act. *(Jimenez vs. Rabot, supra.)*

(3) When a *sale is made by auction* the entry made by the auctioneer in his sales book at the time of sale, of the details mentioned in the law (Art. 1403[2, d].), is a sufficient memorandum even if such entry is not signed by the party sought to be charged.

(4) The *note or memorandum required by the Statute of Frauds* need not be contained in a single document, nor, when contained in two or more papers, need each paper to be sufficient as to contents and signature to satisfy the Statute. Two or more writings properly connected may be considered together, matters missing or uncertain in one may be supplied or rendered certain by another, and their sufficiency will depend on whether taken together, they meet the requirements of the Statute as to contents and as to signature, as considered separately.

Above rule is frequently applied to two or more, or a series of, letters or telegrams, or letters and telegrams sufficiently connected to allow their consideration together; but any other documents can be read together when one refers to the other. Thus, the rule has also been applied to a letter and an order of court or order for goods or a deposition or check; a receipt and a check, etc. The number of papers connected to make out a memorandum is immaterial. (see 3 C.J.S. 656-659.)

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[6]Art. 1874. When a sale of a piece of land or any interest therein is through an agent, the authority of the latter shall be in writing; otherwise, the sale shall be void. (n)

Under the Statute of Frauds, the contents of a note or memorandum may be considered as the contract itself, except as to the form. (Yuvienco vs. Dacuycuy, 104 SCRA 668 [1981].)

ILLUSTRATIVE CASE:

*The contract of sale was entered into orally but all the requirements of the contract are present in two separate instruments signed by both parties.*

*Facts:* After the liberation of the Philippines, both B and H were accused of collaboration for which reason the Treasury Department of the United States ordered the freezing of their properties under the law known as "Trading with the Enemy Act." Under the provisions of the Act, both B and H could not sell or dispose of their properties without first securing the permit required by it, and so to comply with this requirement, both B and H (representing Magdalena Estate, Inc., as its president) filed separately an application with said Department for the purchase and sale of the property in litigation known as Crystal Arcade.

According to H, B offered to sell his undivided 1/3 interest in the property for P200,000 to H, which offer was accepted, and that inspite of the acceptance of the offer, B refused to accept the payment of the price. For these reasons H, now asks for specific performance and damages. B claims that there was no written contract of sale, invoking thus the Statute of Frauds in his defense.

*Issue:* Do the applications for purchase and sale with the Treasury Department partake of the nature of a note or memorandum within the purview of the Statute of Fraud?

*Held:* Yes. Bearing in mind the foregoing rules (see No. 4), the applications, whether considered separately or jointly, satisfy all the requirements of the Statute as to contents and signature, and, as such, they constitute sufficient proof to evidence the agreement in question.

In both applications, all the requirements of a contract are present, namely, the parties, the price or consideration, and the subject-matter. In the application of B which is signed by him, he appears as the seller and H, as the purchaser, the former's interest in the Crystal Arcade as the subject matter, and the sum of P200,000.00 as the consideration. The application of H states specifically that a portion of the sum of P400,000.00 which is desired to be raised as loan will be used for the purchase of the 1/3 interest of B which portion undoubtedly refers to the sum of P200,000.00 mentioned in B's application. This can be plainly seen by harmonizing together the two applications. *(Berg vs. Magdalena Estate, Inc., 92 Phil. 110 [1953].)*

**Enforceability of electronic transactions.**

R.A. No. 8792, otherwise known as the "Electronic Commerce Act of 2000,[7] gives legal recognition to electronic commercial and non-commercial transactions which include domestic and international dealings, arrangements, contracts and exchanges and storage of information.

(1) *Legal recognition of electronic data message.* — Information shall not be denied validity or enforceability solely on the ground that it is in the form of an electronic data message purporting to give rise to such legal effect, or that it is merely incorporated by reference in that electronic data message. (Sec. 6, *Ibid.*)

(2) *Legal recognition of electronic documents.*[8] — Electronic documents shall have the legal effect, validity or enforceability as any other document or legal writing. (Sec. 7, *Ibid.*; on this particular topic, see other provisions under Article 1358.)

(3) *Legal recognition of electronic signatures.* — An electronic signature on the electronic document shall be equivalent to the signature of a person on a written document if the signature is an electronic signature and proved by showing that a prescribed procedure, not alterable by the parties interested in the electronic document, existed under which —

(a) A method is used to identify the party sought to be bound and to indicate said party's access to the electronic document nec-

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[7]For definition of terms and other provisions, see Comments under Arts. 1323 and 1358.

[8]Sec. 1. *Electronic Documents as functional equivalent of paper-based documents.* — Whenever a rule of evidence refers to the term writing, document record, instrument, memorandum, or any other form, such term shall be deemed to include an electronic as defined in these Rules. (Rule 3, Rules on Electronic Evidence.)

Sec. 1. *Burden of proving authenticity.* — The person seeking to introduce an electronic document in any legal proceeding has the burden of proving its authenticity in the manner provided in the Rule. (Rule 5, *Ibid.*)

The Act considers an electronic data message or an electronic document as the functional equivalent of a written document for evidentiary purposes. The Rules on Electronic Evidence (A.M. No. 01-7-01-SC) effective Aug. 1, 2001.) regards an electronic document as admissible in evidence if it complies with the rules on admissibility prescribed by the Rules of Court and related laws in the manner prescribed by the said Rules. An electronic document is also the equivalent of an original document under the Best Evidence Rule, if it is a print-out or output readable by sight or other means shown to reflect the data accurately. Thus, to be admissible in evidence as an electronic data message or to be considered as the functional equivalent of an original document under the Best Evidence Rule, the writing must foremost be an "electronic data message" or an "electronic document." (MCC Industrial Sales Corp. vs. Ssangyong Corp., 536 SCRA 808 [2007].)

essary for his consent or approval through the electronic signature;

(b) Said method is reliable and appropriate for the purpose for which the electronic document was generated or communicated, in the light of all circumstances, including any relevant agreement;

(c) It is necessary for the party sought to be bound, in order to proceed further with the transaction, to have executed or provided the electronic signature; and

(d) The other party is authorized and enabled to verify the electronic signature and to make the decision to proceed with the transaction authenticated by the same. (Sec. 8, *Ibid.*)

"Electronic signature"[9] refers to any distinctive mark, characteristic and/or sound in electronic form, representing the identity of a person and attached to or logically associated with the electronic data message or electronic document or any methodology or procedures employed or adopted by a person and executed or adopted by such person with the intention of authenticating or approving an electronic data message or electronic document. (Sec. 5[e], *Ibid.*)

(4) *Admissibility and evidential weight of electronic data messages or electronic documents.* — In any legal proceedings, nothing in the application of the rules on evidence shall deny the admissibility of an electronic data message or electronic document in evidence —

(a) On the sole ground that it is in electronic form, or

(b) On the ground that it is not in the standard written form, and the electronic data message or electronic document meeting, and complying with the requirements under Sections 6 to 7 of the Act (Legal recognition of electronic data messages and electronic

[9] "Digital signature" refers to an electronic signature consisting of a transformation of an electronic document or an electronic data message using an asymmetice or public cryptosystem such that a person having the initial untransformed electronic document and the signer's public key can accurability determine: (1) whether the transformation was created using the private key that corresponds to the signer's public key; or (2) whether the initial electronic document had been altered after the transformation was made. For purposes of the Rules on Electronic Evidence, an electronic signature includes digital signatures. (Sec. 1[e], [j], Rule 2, Rules on Electronic Evidence.) An electronic signature or a digital signature is admissible in evidence as the functional equivalent of the signature of a person document if authenticated in the manner prescribed by the Rules on Electronic Evidence.

documents) shall be the best evidence of the agreement and transaction contained therein.

In assessing the evidential weight of an electronic data message or electronic document, the reliability of the manner in which it was generated, stored or communicated, the reliability of the manner in which its originator was identified, and other relevant factors shall be given due regard. (Sec. 12, *Ibid.*)

(5) *Recognition by parties of electronic data message or electronic document.* — As between the originator and the addressee of an electronic data message or electronic document, a declaration of will or other statement shall not be denied legal effect, validity or enforceability solely on the ground that it is in the form of an electronic data message or electronic document. (Sec. 17, *Ibid.*)

A contract shall not be denied validity or enforceability on the sole ground that it is in the form of an electronic data message or electronic document, or that any or all of the elements required under existing laws for the formation of the contract is expressed demonstrated and proved by means of electronic data messages or electronic documents.[10] (Sec. 16[1], *Ibid.*)

**ART. 1404. Unauthorized contracts are governed by Article 1317 and the principles of agency in Title X of this Book.**

**ART. 1405. Contracts infringing the Statute of Frauds, referred to in No. 2 of Article 1403, are ratified by the failure to object to the presentation of oral evidence to prove the same, or by the acceptance of benefits under them.**

### Modes of ratification under the Statute.

The ratification of contracts infringing the Statute of Frauds may be effected in two ways:

(1) *by failure to object* to the presentation of oral evidence to prove the contract. The failure to so object amounts to a waiver and makes the contract as binding as if it had been reduced to writing. (see Domalagan

[10]Sec. 1. *Original of an Electronic Document.* — An electronic document shall be regarded as the equivalent of an original document under the Best Evidence Rule if it is a print-out or output readable by sight or other means, shown the reflect the data accurately. (Rule 4, Rules on Electronic Evidence.)

vs. Bolifer, 33 Phil. 471 [1916]; Conlu vs. Araneta, 15 Phil. 587 [1910].) Cross examination of a witness testifying orally on the contract with respect to matters inadmissible under the Statute amounts to failure to object (Abrenica vs. Gonda, 34 Phil. 739 [1916]; Tongco vs. Vianzon, 50 Phil. 698 [1927].); and

(2) *by acceptance of benefits* under the contract. In this case, the contract is no longer executory and, therefore, the Statute does not apply. This rule is based upon the familiar principle that one who has enjoyed the benefits of a transaction should not be allowed to repudiate its burdens. (see Rodriguez vs. Court of Appeals, 29 SCRA 419 [1969].) It is also an indication of a party's consent to the contract as when he accepts partial payment or delivery of the thing sold thereby precluding him from rejecting its binding effect. (Clarin vs. Relona, 127 SCRA 512 [1984].)

**ART. 1406. When a contract is enforceable under the Statute of Frauds, and a public document is necessary for its registration in the Registry of Deeds, the parties may avail themselves of the right under Article 1357.**

### Right of a party where contract enforceable.

For the application of this provision, there must be a valid agreement and the agreement must not infringe the Statute of Frauds.

(1) Accordingly, a party to an oral sale of real property cannot compel the other to put the contract in a public document for purposes of registration because it is unenforceable (Art. 1403[2, e].) unless, of course, it has been ratified. (Art. 1405.)

(2) Similarly, the right of one party to have the other execute a public document is not available in a donation of realty when it is in a private instrument because the donation is void. (Art. 1356.)

**ART. 1407. In a contract where both parties are incapable of giving consent, express or implied ratification by the parent, or guardian, as the case may be, of one of the contracting parties shall give the contract the same effect as if only one of them were incapacitated.**

**If ratification is made by the parents or guardians, as the case may be, of both contracting parties, the contract shall be validated from the inception.**

**When unenforceable contract becomes a voidable contract.**

Where both parties to a contract are incapable of giving consent, the contract is unenforceable. (Art. 1403[3].) However, if the parent or guardian, as the case may be, of either party, or if one of the parties after attaining or regaining capacity, ratifies the contract, it becomes voidable. (see Arts. 1390, 1394.)

A deed of extrajudicial partition and sale entered into by a surviving widow who had no authority or had acted beyond her powers as natural guardian, conveying the individual share of her minor children who were not parties to the contract, never ratified the deed and, in fact, questioned its validity, is not a voidable contract under Article 1350 but unenforceable under Articles 1403(1) and 1317, and, therefore, no restitution may be ordered from them either as to the portion of the purchase price which pertains to their share in the property or at least as to that portion which benefited them because the law does not sanction any. The contract having remained unenforceable, Article 1399 is not applicable. (Badillo vs. Ferrer, 152 SCRA 407 [1987].)

**When unenforceable contract becomes a valid contract.**

If the ratification is made by the parents or guardians, as the case may be, of both contracting parties, or by both contracting parties after attaining or regaining capacity, the contract is validated and its validity retroacts to the time it was entered into. (see Art. 1396.)

**ART. 1408. Unenforceable contracts cannot be assailed by third persons.**

**Right of third persons to assail an unenforceable contract.**

Strangers to a voidable contract cannot bring an action to annul the same (see Art. 1397.); neither can they assail a contract because of its unenforceability. The benefit of the Statute can only be claimed or waived by one who is a party or privy to the oral contract, not by a stranger. (Ayson vs. Court of Appeals, 97 Phil. 965 [1953].) An action for rescission may be brought by a third person.

EXAMPLES:

(1) S sells a parcel of land to B. The contract is oral. C binds himself in writing for the performance by B of his obligation.

In an action by S to recover the purchase price, C cannot assail that the contract between S and B for being unenforceable under the Statute of Frauds. C is a stranger to the contract.

(2) Under a verbal contract, S sells a parcel of land to B.

In an action for ejectment by B against C, the person in possession, the latter cannot set up the defense of the Statute of Frauds.

(3) In the preceding example, suppose C maliciously induces S not to sell the land to B so that S sells the land to another.

In an action by B against C for damages (see Art. 1314.), the latter cannot also plead the Statute of Frauds.

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# Chapter 9

# VOID OR INEXISTENT CONTRACTS*

**ART. 1409. The following contracts are inexistent and void from the beginning:**

**(1) Those whose cause, object or purpose is contrary to law, morals, good customs, public order or public policy;**

**(2) Those which are absolutely simulated or fictitious;**

**(3) Those whose cause or object did not exist at the time of the transaction;**

**(4) Those whose object is outside the commerce of men;**

**(5) Those which contemplate an impossible service;**

**(6) Those where the intention of the parties relative to the principal object of the contract cannot be ascertained;**

**(7) Those expressly prohibited or declared void by law.**

**These contracts cannot be ratified. Neither can the right to set up the defense of illegality be waived.**

## Meaning of void contracts.

*Void contracts* are those which, because of certain defects, generally produce no effect at all. They are considered as inexistent from its inception or from the very beginning.

The expression "void contract" is, therefore, a contradiction in terms. However, the expression is often loosely used to refer to an agreement tainted with illegality.

*New, except Articles 1411 and 1412.

**Meaning of inexistent contracts.**

On the other hand, *inexistent contracts* refer to agreements which lack one or some or all of the elements (*i.e.*, consent, object, and cause) or do not comply with the formalities which are essential for the existence of a contract.

**Characteristics of a void or inexistent contract.**

They are as follows:

(1) Generally, it produces no effect whatsoever, being void or inexistent from the beginning;

(2) It cannot be cured or validated either by time or ratification[1] (Art. 1409, par. 2.);

(3) The right to set up the defense of illegality, inexistence, or absolute nullity cannot be waived *(Ibid.)*;

(4) The action or defense for the declaration of its illegality, inexistence, or absolute nullity does not prescribe (see Art. 1410.);

(5) The defense of illegality, inexistence, or absolute nullity is not available to third persons whose interests are not directly affected (see Art. 1421.);

(6) It cannot give rise to a valid contract. (see Art. 1422.); and

(7) Its invalidity can be questioned by anyone affected by it. (see Nazareno vs. Court of Appeals, 343 SCRA 637 [2000].)

The above characteristics distinguish a void contract from the other defective contracts.

**Effects of a void or inexistent contract.**

A void contract[2] produces no effect whatsoever either against or in favor of anyone. It vests no rights and creates no obligations; hence,

[1]The ratification may be in the nature of a new contract. (see Arroyo vs. Gerona, 58 Phil. 266 [1933] under Article 1347.)

[2]A contract that is void for being illegal, may produce legal effects. (see Arts. 1411-1412.) But a contract that is inexistent because there is absolutely no consent, object, or cause, cannot produce any effect whatsoever.

it does not create, modify, or extinguish the juridical relation to which it refers. (Tongoy vs. Court of Appeals, 123 SCRA 99 [1933], citing IV Tolentino, Civil Code of the Philippines 592 [1973 Ed.]; Chavez vs. Presidential Commission on Good Government, 307 SCRA 394 [1999].) The parties have no rights which they can enforce and the court cannot lend itself to its enforcement. (Homena vs. Casa, 157 SCRA 232 [1988].) A void or inexistent contract is equivalent to nothing. (Republic vs. Lao, 489 SCRA 424 [2006].) There is nothing to ratify. If a void contract has already been performed, the restoration of what has been given is in order. (Nool vs. Court of Appeals, 276 SCRA 149 [1997].)

An illegal contract, however, may produce effects under certain circumstances where the parties are not of equal guilt. (see Arts. 1411-1412.) The other defective contracts are susceptible of ratification and the corresponding action may prescribe.

**Equity as ground to uphold void contract.**

Equity, which has been aptly described as "justice outside legality," is applied only in the absence of and never against statutory law or judicial rules of procedure. When applicable, positive rules should pre-empt and prevail over all abstract arguments based only on equity. (Mendiola vs. Court of Appeals, 258 SCRA 492 [1996].)

Courts exercising equity jurisdiction are first and foremost courts of law bound by rules of law and have no arbitrary discretion to disregard them. Equitable reasons will not control against any well-settled rule of law or public policy. While equity might tilt on the side of one party, the same cannot be enforced so as to overrule positive provisions of law in favor of another. Thus, equity cannot give validity to a void contract. It cannot supplant or contravene the law. The rule must stand no matter how harsh it may seem, *dura lex sed lex.* (Arsenal vs. Intermediate Appellate Court, 143 SCRA 40 [1986]; Valdeveso vs. Damalerio, 451 SCRA 664 [2005].)

ILLUSTRATIVE CASE:

*Third party directly affected by a void contract was guilty of bad faith.*

*Facts*: In violation of the Public Land Act *(infra.)*, S sold to B within the five-year prohibitory period a four-(4)-hectare homestead land. Concededly, the sale was void. Subsequently, S sold to T his remaining

three (3) hectares of land without S knowing the deed of sale covered that portion sold to B. T acted in bad faith.

*Issue:* Who is entitled to the portion of the land in question?

*Held:* To uphold T's claim of ownership would be contrary to the well-entrenched principle against unjust enrichment consecrated in our Civil Code to the end that in cases not foreseen by the lawmaker no one may unjustly benefit himself to the prejudice of another.

The equities of the case lean in favor of B who, since the sale to him, has been in possession of the land which was almost acquired in an underhanded manner by T. However, B was himself guilty of transgressing the law by entering into the transaction clearly prohibited by law. It is a long standing principle that equity follows the law. If, on the basis of equity, B's claim over the land which is anchored on the void contract is to be upheld, it would, in effect, be giving life to a void contract.

In cases where the homestead has been subject of void conveyances, the law still regards the original owner subject to escheat proceedings by the State. The *pari delicto* doctrine cannot be invoked to defeat the policy of the State; neither may the doctrine of estoppel give a validating effect to a void contract which is prohibited by law or against public policy. It is not within the competence of a citizen to barter away what public policy by law seeks to preserve.

For the above reasons, the sale of the four-hectare portion of the homestead to B as well as the sale of the same to T are null and void. The Register of Deeds is ordered to cancel the title issued to T and reissue the original title in favor of S who shall reimburse B the price to the sale. The value of the improvements made on the land by B and the interests on the purchase price are compensated by the fruits received by B from long possession of the homestead. *(Arsenal vs. Intermediate Appellate Court, supra.)*

### Instances of void or inexistent contracts.

(1) *Contracts whose cause, object or purpose is contrary to law, etc.* — The contract of the parties must conform with the law in force at the time it is executed. But the right of a party under such a contract cannot be affected by a subsequent law removing or eliminating such right. Thus, where at the time the contract was entered into there was as yet no statute fixing a ceiling on rentals and prohibiting the landholder from demanding an increase thereof, the landholder has a right to demand an increase to the limit authorized by law. (Cabatan vs. Court

of Appeals, 95 SCRA 323 [1980].) See comments and examples under Articles 1306, 1352, and 1353.

(2) *Contracts which are absolutely simulated or fictitious.* — A contract of sale is void where the price, which appears thereon as paid, has in fact never been paid. (Catindig vs. Heirs of Catalina Roque, 74 SCRA 83 [1976]; Gardner vs. Court of Appeals, 13 SCRA 600 [1984].) The failure of the petitioners to take exclusive possession of the property allegedly sold to them, or in the alternative, to collect rentals from the alleged vendee is contrary to the principle of ownership and a clear badge of simulation that renders the transaction void, it appearing that the alleged deed of sale was merely designed as an accommodation for purposes of loan with the SSS. (Santiago vs. Court of Appeals, 278 SCRA 98 [1997].) See comments and examples under Articles 1345 and 1346.

(3) *Contracts without cause or object.* — The phrase "did not exist at the time of the transaction" does not apply to a future thing which may legally be the object of a contract. See comments and examples under Articles 1347, 1352, and 1353. A contract without consideration is void. A transferor can recover the object of such contract by *accion reinvindicatoria* and any possessor may refuse to deliver it to the transferee, who cannot enforce the transfer. (Modina vs. Court of Appeals, 317 SCRA 696 [1999].)

(4) *Contracts whose object is outside the commerce of men.* — See comments and examples under Articles 1347 and 1348.

(5) *Contracts which contemplate an impossible service.* — See comments and examples under Articles 1347 and 1348. Where the sellers can no longer deliver the object of the sale to the buyers, as the latter themselves have already acquired title and delivery thereof from the rightful owner, the contract of sale may be deemed to be inoperative and may thus fall, by analogy under No. (5) of Article 1409, since delivery of ownerships is no longer possible. (Nool vs. Court of Appeals, 276 SCRA 149 [1997].)

(6) *Contracts where the intention of the parties relative to the object cannot be ascertained.* — See comments and example under Article 1378, par. 2.

(7) *Contracts expressly prohibited or declared void by law.* — Where the illegality of the contract proceeds from an express prohibition or declaration by law, and not from any intrinsic illegality, the contract

is not illegal *per se*.[3] (EPG Construction Co. vs. Vigilar, 354 SCRA 566 [2001]; Dept. of Health vs. C.V. Cachuela, 475 SCRA 218 [2006]; see Art. 1416.) Below are examples of contracts which are prohibited or declared void by law.

(a) Contracts upon future inheritance except in cases expressly authorized by law. (Art. 1347.)

(b) Sale of property between husband and wife except when there is a separation of property. (Art. 1490.)

(c) Purchase of property by persons who are specially disqualified by law (like guardians, agents, executors, administrators, public officers and employees, judges, lawyers, etc.) because of their position or relation with the person or property under their care. (Art. 1491.)

ILLUSTRATIVE CASE:

*Property in litigation was purchased by a person at an inadequate price in collusion with the seller's counsel to whom the property was subsequently transferred by the vendee.*

*Facts:* According to the complaint filed by H and I, as heirs of the deceased D, they were able to recover in a civil case, a parcel of land belonging to D. They were assisted by their lawyer L. The complaint alleged that L, taking advantage of the ignorance of his clients, succeeded in getting them to sell the land at an inadequate price to B a few days after the decision became final and executory. It alleged that the sale was fictitious and that eight months later, another fictitious sale was made transferring the land to L himself.

[3] "According to respondent, 'sans showing of certificate of availability of funds, the implied contracts are considered fatally defective and considered inexistent and void *ab initio*.' Respondent concludes that 'inasmuch as the additional work done was pursued in violation of the mandatory provisions of the laws concerning contracts involving expenditure of public funds and in excess of the public official's contracting authority, the same is not binding on the government and impose no liability therefor.' Although this Court agrees with respondent's postulation that the 'implied contracts,' which covered the additional constructions, are void, in view of violation of applicable laws, auditing rules and lack of legal requirements, we nonetheless find the instant petition laden with merit and uphold, in the interest of substantial justice, petitioners-contractors' right to be compensated for the 'additional constructions' on the public works housing project, applying the principle of quantum meruit. x x x To our mind, it would be the apex of injustice and highly inequitable for us to defeat petitioners-contractors' right to be duly compensated for actual work performed and services rendered, where both the government and the public have, for years, received and accepted benefits from said housing project and reaped the fruits of petitioners-contractors' honest toil and labor."

In his motion to dismiss, L argued that since the sale were executed after the decision in the civil case became final and executory, they were not void *ab initio* but merely voidable at the instance of the vendor under the rule laid down in *Wolfson vs. Estate of Enriquez*. (20 Phil. 340 [1911].)

*Issue:* Is the sale to L void *ab initio* or merely voidable?

*Held:* "The argument stressed by L x x x is of no consequence to the case at bar not only because the environmental milieu in the cited case is not entirely identical and similar to the facts and motivations sought to be proved by H and I in their complaint, but also because the averments contained in the said complaint will sufficiently permit adducement of facts not only that the sale of the land in question to L, as counsel for H and I in the civil case, was actually perfected while the land in dispute was still in litigation, but also that there was collusion [between] B and L to bring about the assailed transaction, induced primarily by the ascendancy exercised by L over his 'uncouth' clients in order to make it appear that the said land was purchased by a buyer in good faith thereby precluding its legitimate owners from recovering the same in view of the protective provisions of the Land Registration Act towards purchasers in good faith and for value.

Evidently, a contract entered into under such circumstances, to the extent that it prejudices third persons with legitimate claims, is null and void *ab initio." (Ruiz vs. Court of Appeals, 79 SCRA 525 [1977].)*

(d) Compromise agreement with respect to the civil status of persons (see Vda. de Castellvi vs. Castellvi, 77 SCRA 88 [1977].), validity of a marriage or a legal separation, any ground for legal separation, future support, the jurisdiction of courts, or future legitime. (Art. 2035.)

(e) Sale of lands acquired under free patent or homestead provisions within five (5) years after the date of issuance of the patent or grant. (Sec. 118, C.A. No. 141 [Public Land Act], as amended.)

(f) A contract which is the direct result of a previous illegal contract. (Art. 1422.)

(g) "A testamentary provision in favor of a disqualified person, even though made under the guise of an onerous contract, or made through an intermediary, shall be void." (Art. 1031.)

(h) "Any stipulation that household service is without compensation shall be void." (Art. 1689.)

(i) "Every donation or grant of gratuitous advantage, direct or indirect, between the spouses during the marriage shall be void except moderate gifts which the spouses may give each other on the occasion of any family rejoicing. The prohibition shall also apply to persons living

together as husband and wife without a valid marriage." (Art. 87, Family Code [Exec. Order No. 209].)

(j) Under the Constitution (Sec. 14, Art. VI.), members of Congress are prohibited from being financially interested, directly or indirectly, in any contract with the government or any subdivision or instrumentality thereof. (see also Arts. 1782, 1874, 2035, 2088, 2130.)

ILLUSTRATIVE CASE:

*The second sale was entered into to ratify or confirm the first sale which is void.*

*Facts:* S obtained a homestead patent over a land. Within the prohibitive five-year period, S sold the land to B. This sale was evidenced by a deed of sale, but the deed was not registered. About ten (10) years later, S executed another deed of sale over the same parcel of land in favor of B for the same price. This deed was registered and a new certificate was issued in the name of B.

Subsequently, the ownership of the land was placed in issue in various litigations between the vendor and the vendee.

*Issue:* Was the first sale ratified by the second sale?

*Held:* No. "It cannot be claimed that there are two contracts: one of which is undisputably null and void, and another, having been executed after the lapse of the 5-year prohibitory period, which is valid. The second contract of sale is admittedly a confirmatory deed of sale. Inasmuch as the first contract of sale is void for it is expressly prohibited or declared void by law, it, therefore, cannot be confirmed or ratified. x x x." *(Menil and Nayve vs. Court of Appeals, 84 SCRA 453 [1978]*; see also Arsenal vs. Intermediate Appellate Court, *supra.)*

**ART. 1410. The action or defense for the declaration of the inexistence of a contract does not prescribe.**

## Action or defense for declaration of inexistence of a contract.

This action or defense should not be confused with an action for the annulment of a voidable contract.

(1) *Action or defense imprescriptible.* — If a contract is void, a party thereto can always bring a court action to declare it void or inexistent; and a party against whom a void contract is sought to be enforced, can always raise the defense of nullity, despite the passage of time. The defect being permanent and incurable, the action or defense does not

prescribe. (see Constantino vs. Estenzo, 65 SCRA 675 [1975]; Tipton vs. Velasco, 6 Phil. 67 [1906]; Trigal vs. Tobias, 2 SCRA 1154 [1961]; Ruiz vs. Court of Appeals, 79 SCRA 525 [1977].) Mere lapse of time cannot give efficacy to a void contract (Catindig vs. Heirs of Catalina Roque, 74 SCRA 83 [1977].); neither can it be cured by ratification. (Sumipat vs. Banga, 436 SCRA 521 [2004].)

It has been held that the right to file an action for reconveyance on the ground that the certificate of title was obtained by means of a fictitious deed of sale is virtually an action for the declaration of its nullity. An action for reconveyance based on a void contract (*e.g.,* forged deed of sale) is imprescriptible. (Lacsamana vs. Court of Appeals, 288 SCRA 287 [1998]; Heirs of R. Dumaliang vs. Serban, 516 SCRA 343 [2007]; Daclag vs. Machilig, 579 SCRA 556 [2009].)

It is well-settled that as between the parties to a contract, validity cannot be given to it by estoppel if it is prohibited by law or it is against public policy. It is not within the competence of any citizen to barter away what public policy by law seeks to preserve. (Nool vs. Court of Appeals, 276 SCRA 149 [1997].) Laches cannot be set up to resist the enforcement of an imprescriptible legal right. (Heirs of R. Ingjug-Tiro vs. Casals, 363 SCRA 435 [2001]; see Art. 1431.) The positive mandate of Article 1410 should pre-empt and prevail over all abstract arguments based only on equity. An heir can validly vindicate his inheritance despite the lapse of time. (Aznar Brothers Realty Co. vs. Heirs of A. Augusto, 430 SCRA 156 [2004].)

The rule in Article 1410 has been applied even before the effectivity of the new Civil Code. (Maneclang vs. Baun, 208 SCRA 179 [1992].)

(2) *Necessity of judicial declaration.* — Since a void contract has no effect at all, it is, therefore, unnecessary to bring an action to declare it void. It is well within the right of a party to unilaterally cancel and treat as avoided a void contract. (G. Razon, Inc. vs. Philippine Ports Authority, 151 SCRA 233 [1988].) In fact, such action cannot logically exist. However, an action to declare the non-existence of the contract can be maintained and in the same action, the plaintiff may recover what he has given by virtue of the contract. (Rongavilla vs. Court of Appeals, 294 SCRA 289 [1998].) It is better that a judicial declaration of nullity be secured not only to give peace of mind to the parties but also to avoid the taking of the law into their own hands.

(3) *Rule where contract not void but merely voidable.* — Voidable contracts can only be annulled by a proper action in court. (Art. 1390, last par.) within four (4) years from the time the cause of action accrues. (Art. 1391.) In an action to enforce a voidable contract, the defendant cannot attack its validity by way of defense and then ask for its annulment. But he can do so in a counterclaim because it is in the nature of a complaint.

Article 1410 cannot possibly apply to last wills and testaments. (Gallanosa vs. Arcangel, 83 SCRA 676 [1978].) They are not contracts.

ILLUSTRATIVE CASES:

1. *When a contract is inexistent for lack of consideration.*

*Facts:* After the death of D, special proceedings were begun in court for the settlement of his estate. H, etc. and I were the heirs of D. In 1939, a deed of assignment of inheritance was executed by H, etc., by which for P1.00, H, etc., assigned their shares to a parcel of land to B. The deed mentioned that it was the express will of the decedent D that the land belonged to B. The deed was registered on March 16, 1940. On September 4, 1958, H, etc., filed a complaint for annulment of the deed of assignment and the reconveyance to them of their shares in the property.

The Court of Appeals held that the deed in question was void *ab initio* and inexistent on the ground that real consent was wanting and the consideration of P1.00 was so shocking to the conscience that there was in fact no consideration; hence, the action for the declaration of the contract's inexistence did not prescribe pursuant to Article 1410.

*Issue:* May the action of H, etc. be considered as one to declare the inexistence of a contract for lack of consideration?

*Held:* No. It is total absence of cause or consideration that renders a contract absolutely void and inexistent. In the case at bar, consideration was not absent. The sum of P1.00 appears in the document as one of the considerations for the assignment of inheritance. In addition — and this is of great legal import — the document recites that the decedent D had during his lifetime, expressed to the signatories to the contract that the property subject matter thereof rightly and exclusively belonged to B. This acknowledgment by the signatories definitely constitutes valuable consideration for the contract. The action has prescribed. *(Carantes vs. Court of Appeals, 76 SCRA 514 [1977].)*

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2. *Right of vendor to set up the inexistence of a contract of sale even against bona fide successors of vendee.*

*Facts:* The City of Manila sold in 1971 to the Elks Club a portion of the reclaimed extension of the old Luneta. The property was sold by Elks Club to FDC, which claimed to be a purchaser in good faith.

The sale was later questioned by the City of Manila as void for being a prohibited sale of property of the public dominion.

*Issues:* (1) Would there be an impairment of the obligation of contracts if the sale were declared void?

(2) May the City of Manila set up the inexistence of the sale against FDC?

*Held:* (1) No, for there was, in contemplation of law no contract at all. The buyer acquired no right by virtue of the sale which was void and inexistent for lack of subject matter. It suffered from an incurable defect that could not be ratified by the lapse of time or by express ratification.

(2) Yes. It can be set up against anyone who asserts a right arising from the sale, not only against the first vendee but also against all its successors. The doctrine of *bona fide* purchaser without notice does not apply where there is total absence of title in the vendor. (see Art. 1459.) Good faith of the purchaser cannot create title where none exists. *(Manila Lodge No. 761, Benevolent and Protective Order of the Elks, Inc. vs. Court of Appeals, 73 SCRA 162 [1976].)*

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3. *Authority of court to summarily dismiss, on ground of prescription, a complaint before answer is filed where the action is for the declaration of the inexistence of a contract.*

*Facts:* X filed a complaint against Y for the annulment of a deed of extrajudicial settlement of estate of a deceased person. The complaint is predicated on the ground that the deed was "simulated," "null and void," and "done in bad faith." It prayed that the deed be declared null and void. Y alleged that the action had prescribed as fourteen (14) years had elapsed from the date of the extrajudicial settlement.

The lower court ruled that the "the filing of the action is time-barred" and dismissed the case.

*Issue:* Is the order of dismissal correct?

*Held:* No. Considering the allegations and prayer in the complaint and the provisions of Articles 1409(2) and 1410, the court should not have summarily dismissed X's complaint, instead, it should have required Y to answer the complaint, deferred action on the special defense of

prescription, and ordered the parties to proceed to a trial on the merits. *(Constantino vs. Estenzo, 65 SCRA 675 [1975].)*

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4. *Authority of court to dismiss, on ground of prescription, an action for annulment of a deed of sale based on fraud and absence of consideration.*

*Facts:* In his complaint against B to annul a deed of sale, S alleged that he was surprised to find that the deed was a sale for the document had been represented by B to be for a different purpose. The action of S is based upon the grounds that: (1) there is fraud in securing his signature in said deed; and (2) there was no consideration given at the time of the transaction.

B raised the defense of prescription, contending that since the action was based on fraud it should have been brought within four years from the time of the discovery of the document. (see Art. 1391.)

*Issue:* Has S's action prescribed?

*Held:* No. His action is to declare void and inexistent the deed of sale, which action is imprescriptible. *(Encarnacion vs. Galvan, 85 SCRA 526 [1978].)*

**ART. 1411. When the nullity proceeds from the illegality of the cause or object of the contract, and the act constitutes a criminal offense, both parties being in *pari delicto*, they shall have no action against each other, and both shall be prosecuted. Moreover, the provisions of the Penal Code relative to the disposal of effects or instruments of a crime shall be applicable to the things or the price of the contract.**

**This rule shall be applicable when only one of the parties is guilty; but the innocent one may claim what he has given, and shall not be bound to comply with his promise. (1305)**

## Rule on *pari delicto*.

Generally, parties to a void agreement cannot expect the aid of the law; the courts leave them as they are, because they are deemed *in pari delicto*, or "in equal fault." *In pari delicto* is "a universal doctrine which holds that no action arises, in equity or at law, from an illegal contract; no suit can be maintained for its specific performance, or to recover the property agreed to be sold or delivered, or money agreed to be paid, or damages for its violation; and where the parties are *in pari delicto*, no affirmative relief of any kind will be given to one against the other." Indeed, one who seeks equity and justice must come to court with clear hands.

This rule, however, is subject to exceptions (Arts. 1411-1419.) that permit the return of that which may have been given under a void contract. (Hulst vs. PR Builders, Inc., 532 SCRA 74 [2007].)

### Rules where contract illegal and the act constitutes a criminal offense.

Under Article 1411, it must be shown that the nullity of the contract proceeds from an illegal cause (*e.g.*, desire to evade the payment of taxes) or object, and the act of executing said contract constitutes a criminal offense. (Ramirez vs. Ramirez, 485 SCRA 92 [2006]; Beltran vs. Villarosa, 585 SCRA 283 [2009].)

(1) *Where both parties are in pari delicto.*[4] — The following are the effects of a contract whose cause or object constitutes a criminal offense and both parties are equally guilty in *pari delicto:*

(a) The parties shall have no action against each other, or as stated in the legal maxim: *In pari delicto melior est conditio defendentis;*

(b) Both shall be prosecuted; and

(c) The things or the price of the contract, as the effects or instruments of the crime, shall be confiscated in favor of the government. (par. 1; Art. 48, Revised Penal Code.)

The rule that parties to an illegal contract, if equally guilty, will not be aided by the law but will both be left where it finds them, has been interpreted as barring a party from pleading the illegality of the bargain either as a cause of action or as a defense. (Liquez vs. Court of Appeals, 102 Phil. 577 [1957]; Perez vs. Herranz, 7 Phil. 695 [1907], *infra.*) The general rule is that neither can seek relief from the courts, and each must bear the consequences of

[4]The rule on *pari delicto* is a rule in civil law. It is principally governed by Articles 1411 and 1412 of the Civil Code, and presupposes a situation where the parties are in culpability similarly situated, *i.e., in eodem loco.* That this rule can by no means apply in a criminal case is evidenced by said Article 1411 in the first sentence. Secondly, in view of the broader grounds of public policy, the rule may not be invoked against the State. Thirdly, in the prosecution of public crimes, the complainant is the State, *i.e.,* the People of the Philippines, while the private offended party is but a complaining witness. Any criminal act perpetrated by the latter on the occasion of the commission of the crime, or which may have given rise to the criminal act imputed to the accused is not the act or conduct of the State and can by no means bind it under the doctrine of *pari delicto*. (Ubarra vs. Mapalad, 220 SCRA 224 [1993]; Evangelista vs. People, 227 SCRA 144 [1993].)

his acts. (Lita Enterprises, Inc. vs. Intermediate Appellate Court, 129 SCRA 79 [1987].) Being *participes criminis*, having entered into the transaction with open eyes, and having benefited from it, said parties should be held in estoppel to assail and annul their own deliberate acts. (San Agustin vs. Court of Appeals, 358 SCRA 348 [2001].)

The application of the *pari delicto* principle is not absolute, as there are exceptions to the application. *(infra.)* One of these exceptions is where the application of the rule would violate well established public policy. (Silagan vs. Intermediate Appellate Court, 196 SCRA 794 [1991]; Pajuyo vs. Court of Appeals, 430 SCRA 492 [2004].) Another exception is when the principle is invoked with respect to inexistent contracts. (Medina vs. Court of Appeals, 317 SCRA 696 [1999], citing Gonzales vs. Trinidad, 67 Phils. 682 [1939].)

ILLUSTRATIVE CASES:

1. *Liability sought to be enforced by a party against another is not based on the illegal contract entered into by them.*

*Facts:* X, captain of a steamer, salvaged a burning vessel with its cargo, by towing it to Manila. In an action against Y, the owner of the cargo, to recover salvage charges, the latter alleged as defense that the salvage was effected for the unlawful purpose of cooperating in the illegal importation of Mexican silver coins, then considered contraband, and that X previously agreed to transfer the same to his own ship and convey it to Aparri.

Y set up a counterclaim for a part of the silver found missing.

*Issues:* (1) Is X entitled to recover the salvage charges?

(2) Should counterclaim be allowed assuming that X actually concealed the missing silver claimed by Y?

*Held:* (1) Yes. The salvage was something independent of the agreement to convey the silver to Aparri and cannot, therefore, be affected by any defects which might have vitiated the latter. The burning of the vessel was an accident unforeseen by Y, regarding which he made no contract with X. The salvage was outside of the terms of the contract between them, which only referred to the transfer of the silver. In conveying the silver to Manila, X rendered possible the discovery of the contraband which would otherwise have been avoided.

(2) No. The concealment of the silver, if it were true, can be regarded as an act of assistance or cooperation in the unlawful importations of the

silver. The crime, if any, being common to both parties, they would have no action against each other under Article 1411. *(Irebar vs. Millat, 5 Phil. 362 [1905].)*

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2. *Recovery of money knowingly loaned to be corruptly used by a candidate in an election.*

*Facts:* S was a candidate for Governor in 1951. H was his campaign manager. S needed funds to finance his campaign funds which H could provide. H agreed to make cash advances to S. To evade the election law (which limited election expenses of candidates and prohibited a public utility operator from making any contribution or expenditure in an election campaign), loans or advances were made to S through H's trusted employees and S, in turn, executed promissory notes and a lease contract.

Several years after the elections, S brought action to have the notes and lease declared null and void on the ground that they violated the prohibitions in the election law. The administratrix of H's estate argued that Section 48 of the (former) Election Code did not apply to H because S did not prove that H knew that the loans and the rentals for the lease would be used by S "as would exceed" the governor's salary for one (1) year.

*Issue:* May the money loaned be recovered?

Held: "There is a ruling that money knowingly loaned to be corruptly used in an election cannot be recovered . . . The knowledge of the lender and the borrower to a promissory note that the money borrowed from the payee was to be used, and actually used, to bring the electors to vote for the maker was held to be a good defense to an action on the note.

H admitted the allegations in S's complaint that H was aware that S would incur campaign expenses exceeding the governor's annual salary and that S's disbursements exceeded that amount. . . Moreover, the Court of Appeals found that 'H was fully aware of the purpose and objective in consummating the lease contract and the promissory notes, that is, to sustain the campaign funds of plaintiff S' and that 'H cannot feign lack of knowledge of that purpose.'

The contention that H was less guilty or that his acts were less excusable than those of S is not meritorious because without H's money, the offenses in question could not have been perpetrated. In fact, the use of H's trusted employees as dummies was his own idea.

Those factual findings are conclusive and cannot be reviewed in this appeal. So, the rule that an agreement is illegal if it involves the

commission of a crime applies to this case. From the finding of the Court of Appeals that the lease and the promissory notes were illegal, the logical corollary is that H and S were in *pari delicto* or *participes crimines* or were equally guilty in violating the election law. Accordingly, the respective claims for damages of the parties were dismissed. *(Emilia Vda. de Halili vs. Court of Appeals and F. Suntay, 83 SCRA 633 [1978].)*

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3. *Contract of deposit of U.S. dollars violates Central Bank Circular to sell them to the Central Bank within one (1) business day from receipt.*

*Facts:* The contract executed between B (bank) and D (depositor) states that U.S. dollars in cash were received by B for safekeeping, and the subsequent acts of the parties also showed that the intent was really for B to safely keep the dollars and return it to D. Under the above arrangement the contract of deposit was entered into. In violation of its obligation, B sold the dollars although it credited the peso proceeds of the sale to D's current account. D demanded the return of the U.S. dollars.

Central Bank Circular No. 281 (Nov. 6, 1969) requires that all receipts of foreign exchange by any resident person shall be sold to authorized Central Bank Agents within one (1) business day following the receipt of said foreign exchange. The mere safekeeping of the green bucks without selling them to the Central Bank within (1) business day from receipt is a transaction not authorized by the circular and, therefore, falls under the general class of prohibited transactions.

*Issues:* Can D recover?

*Held:* No. The parties did not intend to sell the dollars to the Central Bank; otherwise, the contract of deposit would never have been entered into. Hence, pursuant to Article 5 of the Civil Code, it is void having been executed against the provisions of a mandatory/prohibitory law. However, it affords neither of the parties a cause of action against the other under Article 1411. The only remedy is one in behalf of the State to prosecute the parties for violating the law. *(Bank of the Phil. Islands vs. Intermediate Appellate Court, 164 SCRA 630 [1988].)*

(2) *Where only one party is guilty.* — If only one party is guilty or both parties are not equally guilty (in *delicto*, but not in *pari delicto)*, the rule in paragraph 1 applies only to the guilty party or the more guilty party. The innocent one or the less guilty may claim what he has given and shall not be bound to comply with his promise. (par. 2.)

**ART. 1412. If the act in which the unlawful or forbidden cause consists does not constitute a criminal offense, the following rules shall be observed:**

**(1) When the fault is on the part of both contracting parties, neither may recover what he has given by virtue of the contract, or demand the performance of the other's undertaking;**

**(2) When only one of the contracting parties is at fault, he cannot recover what he has given by reason of the contract, or ask for the fulfillment of what has been promised him. The other, who is not at fault, may demand the return of what he has given without any obligation to comply with his promise. (1306)**

### Rules where contract unlawful or forbidden but act not a criminal offense.

(1) *Where both parties in pari delicto.* — If the cause of the contract is unlawful or forbidden but there is no criminal offense, the rules are as follows:

(a) Neither party may recover what he has given by virtue of the contract; and

(b) Neither party may demand the performance of the other's undertaking. (see Heirs of M. Avila vs. Court of Appeals, 145 SCRA 541 [1986]; see Villegos vs. Rural Bank of Tanjay, Inc., 588 SCRA 436 [2009].)

No relief can be granted to either party; the law will leave them where they are. (Compania General De Tabacos De Filipinas vs. Court of Appeals, 185 SCRA 284 [1990].) The principle of *pari delicto* is grounded on two (2) premises: *first*, that courts should not lend their good offices to mediating disputes among wrongdoers; and *second*, that denying relief to an admitted wrongdoer is an effective means of deterring illegality. (Acabal vs. Acabal, 454 SCRA 555 [2005].)

EXAMPLE:

X agreed to live as the common-law wife of Y in consideration of the promise on the part of Y to donate a land to X.

Here, the promise of Y has for its consideration an immoral act which does not constitute a crime. Hence, there can be no recovery by one against the other, and neither party may ask for the fulfillment of the other's promise. (see Batarra vs. Marcos, 7 Phil. 156 [1906].)

ILLUSTRATIVE CASES:

1. *Mortgage to creditor by vendee of property sold to him both parties being aware that it is in breach of stipulated condition in favor of vendor.*

*Facts:* PHHC sold to S a lot subject to the condition that within the next 25 years from the date of sale, S would not resell the property except

to PHHC. S subsequently mortgaged the property to Y, both parties being aware of the stipulated condition in favor of PHHC.

*Issue:* Is S entitled to invoke the breach of the condition?

*Held:* No. On the assumption that the mortgage and foreclosure sale violated the said condition, S and Y, as between themselves, were both in *pari delicto,* being *particeps criminis,* as it were in the wrongful transaction, and being equally guilty, neither is entitled to complain against each other. Having entered into the transaction with open eyes, and having benefited from it, said parties should be held in estoppel to assail and annul their own deliberate acts. Since the condition is manifestly in favor of PHHC, only PHHC is entitled to invoke its breach and not S. *(Sarmiento vs. Salud, 45 SCRA 213 [1972]; see San Agustin vs. Court of Appeals, 371 SCRA 348 [2001].)*

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2. *Sale is made by mother to daughter, then to mother and stepfather to circumvent the prohibition against donation between spouses.*

*Facts:* In order to circumvent the prohibition against donation between spouses during their marriage, W sold her fishponds to her daughter, D who, in turn, sold the same to W and H (W's second husband and D's stepfather), thereby converting the property from paraphernal to conjugal and vesting a half interest in H.

A controversy arose between W and the children of H by first marriage.

*Issue:* Can W recover the property?

*Held:* No. The rule *in pari delicto non oritur actio,* denying all recovery to the guilty parties *inter se* applies. W is clearly as guilty as her husband. *(Rodriguez vs. Rodriguez, 20 SCRA 908 [1967].)*

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3. *Opposition to the probate of a will was withdrawn in pursuance of a compromise agreement which is subsequently declared void by the court.*

*Facts:* In a probate proceedings, H, etc. filed an opposition to the admission of the will of T (testator), which named D (judicially adopted daughter of T) as heir. Later, a compromise agreement was entered into between A, etc. and D, whereby in consideration of the acknowledgment made in said agreement by D of H's (etc.) status as duly acknowledged natural children of T, H, etc. withdrew their opposition to the probate of the will, and desisted from presenting proof as to their status as such acknowledged natural children of T and from questioning the legality of the adoption of D.

This compromise agreement was subsequently voided by the Court for being contrary to Article 2055 which declares void a compromise with respect to the civil status of persons.

The court admitted the will to probate after taking the testimony of one of the attesting witnesses to the will. H, etc. contend that were it not for the withdrawal of their opposition, the will could not have been probated on the basis of the testimony of only one attesting witness it being the law that all the three attesting witnesses must indispensably be presented and must testify, when there is an opposition to the admission thereof. (see Secs. 6, 11, Rule 76, Rules of Court.)

*Issue:* May H, etc. recall, withdraw, or otherwise render ineffective what they have already done in performance of their part in the illegal bargain?

*Held:* No. True it is that a compromise agreement on the civil status of persons is not a criminal offense in which the parties to the contract, being in *pari delicto,* are left where they are bound, but since the agreement has been declared contrary to law and void, under Article 1412, H, etc. may no longer continue their opposition and ask the court that the approval of said will be set aside and D be compelled to comply with the requirement of the law making the presentation of all the three attesting witnesses to the will indispensable for its probate. *(Vda. de Castellvi vs. Castellvi, 78 SCRA 88 [1977].)*

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4. *Parties operated taxicabs under an arrangement, commonly known as "kabit system."*

*Facts:* For valuable consideration, L allowed K the use of the former's certificate of public convenience since the latter had no franchise to operate taxicabs. K's cars were registered in the name of L but possession remained in K who operated them under L's trade name.

L was adjudged liable for damages in a civil case for the death of a person as result of the negligence of the driver of one of the taxicabs.

*Issue:* Will a suit by K for the reconveyance of the vehicles proper? Is L entitled to relief for whatever amount he has paid or was declared liable?

*Held:* No. The "*kabit* system" has been identified as one of the root causes of the prevalence of graft and corruption in the government transportation offices. Although not outrightly penalized as a criminal offense, it is invariably recognized as being contrary to public policy, and, therefore, void and existent. *Ex pacto illicito non oritur actio* (No action

arises out of an illicit bargain) is the time-honored maxim that must be applied to the parties in the case at bar.

Under American jurisdiction, the doctrine is stated thus: "The proposition is universal that no action arises, in equity or at law, from an illegal contract. No suit can be maintained for its specific performance, or to recover the property agreed to be sold or delivered, or damages for its violation. The rule has sometimes been laid down as though it was equally universal, that where the parties are *in pari delicto,* no affirmative relief of any kind will be given to one against the other." (citing Pomeroy's Equity Jurisprudence, Vol. 3, 5th Ed., p. 728.)

Having entered into an illegal contract, neither L nor K can seek relief from the courts, and each must bear the consequences of his acts (*Lita Enterprises, Inc. vs. Second Civil Cases Division, IAC, 129 SCRA 79 [1984];* see Teja Marketing vs. Intermediate Appellate Court, 148 SCRA 347 [1987], under Art. 1306.)

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5. *Salesman was given by a selling company a special commission to be given as a kickback to certain employees of purchasing company.*

*Facts:* PP Corporation's salesmen receive regular salaries. To encourage increased sales they also get commissions ranging from 1/4% to 1/2% of generated sales. X received the maximum 1/2% of commission given to the firm's top salesmen. In addition, he was also given 7% commission rebates.

The evidence showed that these rebates were actually kickbacks to certain employees of LT, Inc. purchasing company, responsible for choosing PP corporation as supplier. X was given the full discretion of determining to whom and in what amounts the kickbacks would be given. PP corporation took away from X the account of LT, Inc.

*Issue:* Is PP Corporation liable to pay X the 7% commission on sales to LT, Inc.?

*Held:* Both PP Corporation and X are in *pari delicto*. Neither one may expect positive relief from courts of justice in the interpretation of their contract. The courts will leave them as they were at the time the case was filed. Kickback arrangements in the purchase of supplies, etc. are immoral if not illegal. In government, they would be proper for anti-graft and corrupt practices indictments. In private life, the affected firms will have to devise their own remedial measures. As always, it is the consuming public that suffers. The 7% commission rebates "in this case are extra charges which LT, Inc. top management has to bear and which it

will eventually pass on to the buyers of its products." *(Packaging Products Corporation vs. National Labor Relations Commission, 152 SCRA 210 [1987].)*

(2) *Where only one party is guilty.* — If only one party is guilty or both parties are not equally guilty, the following are the rules:

(a) The guilty party loses what he has given by reason of the contract;

(b) The guilty party cannot ask for the fulfillment of the other's undertaking;

(c) The innocent party may demand the return of what he has given; and

(d) The innocent party cannot be compelled to comply with his promise.

A party to a contract cannot deny its validity after enjoying its benefits and invoke his own misdeeds to exculpate himself conformably with the basic principle in law that he who comes to court must come with clean hands. (Lim v. Queensland Tokyo Commodities, Inc., 373 SCRA 31 [2001].)

EXAMPLE:

If, in the preceding example, X is only a minor, say, of 16 at the time, and Y was a married man of mature years and experience, the principle of *in pari delicto* is not applicable. Y cannot recover the land given by him nor demand the performance of X's undertaking if the latter has not yet complied with her promise. However, X may recover whatever property she may have given by virtue of the contract without any obligation to comply with her promise.

While it may be repugnant to divest Y of the ownership of the property, "the law deems it more repugnant that a party should invoke his own guilt as a reason for relief from a situation into which he had deliberately entered." But if Y has not yet donated the land, it is clear that he can not be compelled to make the donation.

ILLUSTRATIVE CASES:

1. *A wife, erroneously believing her husband would recover from her certain property, was induced by means of fraud by the vendee to sign a fictitious deed of sale of all her property to the latter.*

*Facts:* W and her husband H signed a marital contract of separation. Through the influence of C, whom W regarded with great confidence,

who brought a story to W that H might contest the contract for the separation of the conjugal property, H was induced to sign a fictitious contract of sale of all her property to D, the wife of C and a cousin of W for the price of only 1/3 of their value.

In order to reassure W that they would not take advantage of the fictitious sale, C and D signed a deed of donation of the property of W to be effective in case of death of themselves and their children before the death of W. W asked to be relieved from the agreement.

*Issue:* Under the facts, is W entitled to recover the property?

*Held:* Yes. The agreement is against public policy. W, who was induced to enter into it by means of fraud, is *in delicto,* but not *in pari delicto* with the other party. The deed was procured by misrepresentation sufficient to vitiate the transaction. As the rights of creditors are not affected, justice will be done if the grantor (W) is placed in the position in which she was before these transactions were entered into. *(Bough vs. Cantiveros, 40 Phil. 209 [1919].)*

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2. *Title to a vessel owned by a Filipino citizen and a foreigner was put in the name only of the former to circumvent provision of coastwise law.*

*Facts:* S (company) sold to B a steamer for P58,000.00. The purchase price was paid by check of F, a foreigner. It appeared that of the sum of P58,000.00, F retained an interest amounting to P48,000.00, the other P10,000.00 being furnished by B, but the title was put in his name alone to thwart the provisions of the coastwise law.

Relying upon the illegality of this arrangement, B brought action against F, who was given management of the vessel, to recover exclusive possession of the vessel together with a share of its earnings.

*Issue:* Will B's action prosper?

*Held:* No. B is not entitled to recover the vessel. It is a familiar principle that the courts will not aid either party to enforce an illegal contract, but will leave them both where it finds them; but where the plaintiff can establish a cause of action without exposing its illegality, the vice does not affect his right to recover. The principle applies equally to a defense. The law applicable is found in Articles 1411 and 1412, shutting out from relief either of the two parties to an illegal or vicious contract.

B, however, is entitled to an accounting and to the payment of the share of the earnings due him. In the present case, it is *prima facie* established that as between themselves, B is the owner of a 10/58 interest in the vessel and C, the owner of a 48/58 interest therein. *(Perez vs. Herranz, 7 Phil. 693 [1907].)*

(3) *Where both parties are not guilty.* — If both parties have no fault or are not guilty, the restoration of what was given by each of them to the other is in order. This is because the declaration of nullity of a contract which is void *ab initio* operates to restore things to the state and condition in which they were found before the execution thereof. (Development Bank of the Phils. vs. Court of Appeals, 249 SCRA 331 [1995]; see Art. 1398.)

**When *pari delicto* rule not applicable.**

(1) *Breach of warranty cases.* — It is an elementary principle of law (see Arts. 1495, 1547, and 1555.), as well as of justice and equity that, unless a contrary intention appears, the vendor warrants his title to the thing sold, and that, in the event of eviction, the vendee shall be entitled to the return of the value which the thing sold has at the time of the eviction, be it greater or less than the price of the sale. Cases involving breach of warranty arising from a valid contract of sale are governed in particular by the provisions on Sales, especially by the aforesaid Articles 1495, 1547, and 1555, and Article 1544, regulating the effects of double sale. (Sta. Romana vs. Imperio, 15 SCRA 625 [1965].)

ILLUSTRATIVE CASE:

*Shares of stock of a corporation engaged in tourism were sold without prior approval of Ministry of Tourism as required by law.*

*Facts:* See Illustrative Case No. (5) under Article 1191.

*Issue:* Is the *in pari delicto* doctrine applicable?

*Held:* No. S, the stockholder of the corporation, as the vendor, is obligated not only to transfer the ownership of and deliver, but also to warrant the thing which is the object of the sale, *i.e.*, the shares of stock pursuant to Article 1495[5] of the Civil Code. Consequently, only S is charged with knowledge of the prior approval requirement.

And even assuming both parties are *in pari delicto,* yet the court may interfere and grant relief at the suit of one of them where public policy requires its intervention, even though the result may be that a benefit will be derived by plaintiff who is in equal guilt with defendant. The required approval seeks to insure that shares of stock in a tour operator

[5]Art. 1495. The vendor is bound to transfer the ownership of and deliver, as well as warrant the thing which is the object of the sale. (1461a)

or agency would not be sold to persons unfit to engage in the business of tour operation and is in line with "the policy" of the Government to make the tourism industry a positive instrument towards accelerated national development. *(E.T. Yuchengco, Inc. vs. Velayo, 115 SCRA 307 [1982].)*

(2) *Simulated contracts.* — The maxim does not apply to simulated or fictitious contracts (Arts. 1345, 1346, 1409[2].) or to inexistent contracts which are devoid of consideration. (Arts. 1352, 1409[2]; Castro vs. Escutin, 90 SCRA 349 [1979].) It applies only in case of existing contracts with illegal consideration. (Vasquez vs. Porta, 98 Phil. 490 [1955]; see Rodriguez vs. Rodriguez, 20 SCRA 908 [1967].)

Articles 1411 and 1412 presuppose that there is a cause but the same is unlawful.

ILLUSTRATIVE CASE:

*Right of party to recover what he has given where the contract is simulated.*

*Facts:* S sold to B a parcel of land for P10,000.00. The sale was simulated and S did not receive the alleged price, the idea being to save the property from attachment by C to whom S was indebted. C died and the credit was adjudicated to D with whom S had a subsequent agreement to pay. Thus, the litigation and attachment which S feared were averted.

S brought action against B for the recovery of the land on the ground that the sale was null and void. The trial court dismissed the action, applying Articles 1305 and 1306. (now Arts. 1411 and 1412.)

*Issues:* Are Articles 1411 and 1412 applicable?

*Held:* No. Said articles refer to contracts with an illegal consideration or subject matter, whether the facts constitute an offense or whether the consideration is only rendered illegal. The contract of sale, being onerous, has for its cause or consideration the price of P10,000.00 (Art. 1350.); and both the consideration as well as the subject matter of the contract are lawful. However, as the contract was in itself fictitious and the supposed vendor (S) did not receive the stipulated price, the consideration being thus lacking, said contract is null and void *per se* or non-existent.

The object of the contracting parties or the motives which the vendor had in entering into the simulated contract should not be confused with the consideration which was not present in the transaction. The former, although illegal, neither determine nor take the place of the consideration. *(Gonzales vs. Trinidad, 67 Phil. 682 [1939].)*

(3) *Parties not equally guilty.* — Where the parties are not equally guilty, and where public policy is considered, as advanced by allowing the more excusable of the two to sue for relief against the transaction, relief is given to him. Cases of this character are where the conveyance was wrongfully induced by the grantee through imposition or over-reaching, or by false representations, especially by one in a confidential relation. (13 C.J. 497-499; Bough vs. Cantiveros, 40 Phil. 209 [1919].)

For the *pari delicto* rule to apply, the fault on both sides must be, more or less, equivalent. (Mangayao vs. Lasud, 11 SCRA 158 [1964], *infra.*)

(4) *Against the government.* — It is a cardinal principle of law and well-settled in jurisprudence that the government is not estopped by the neglect or omission of its officers. (Central Azucarera de Tarlac vs. Collector of Internal Revenue, 104 Phil. 653 [1958]; for other cases, see Estoppel [Title IV].)

(5) *Prohibited conveyances under the law.* — An alienation or sale of a homestead executed within the 5-year prohibitory period provided under the Public Land Act is void. *(supra.)* The doctrine may not be invoked in a case of this kind since it would run counter to an avowed fundamental policy of the State that the forfeiture of a homestead is a matter between the State and the grantee or his heirs, and that until the State had taken steps to annul the grant and asserts title to the homestead, the purchaser is, as against the vendor or heirs, no more entitled to keep the land than any intruder. This is particularly true where the vendors of the homestead are unlettered members of a tribe belonging to the cultural minorities. (Arsenal vs. Intermediate Appellate Court, 143 SCRA 40 [1986].)

The contract being void, must be given no effect at all and the parties must be placed in *status quo* which was the condition prevailing before the execution of the contract. (Torres vs. Ventura, 187 SCRA 196 [1990].)

(6) *Constitutional prohibition against alien landholding.* — The Supreme Court has ruled that where a Filipino citizen sells land to an alien who later sells the land to a Filipino, the invalidity of the first transfer is corrected by the subsequent sale, to a citizen. Similarly, where the alien who buys the land subsequently acquires Philippine citizenship, the sale was validated since the purpose of the ban to limit

ownership to Filipinos (Sec. 7, Art. XII, Constitution) has been achieved. In short, the law disregards the constitutional disqualification of the buyer to hold land if the land is subsequently transferred a qualified party, or the buyer himself becomes a qualified party. (Chavez vs. Public Estate Authority, 403 SCRA 1 [2003]; Republic vs. Register of Deeds, 558 SCRA 450 [2008].)

(7) *Other exceptions.* — Articles 1411 and 1412 embody the general principle that when both parties are *in pari delicto,* the law refuses them every remedy and leaves them where they are. However, there are exceptions to this rule. American jurisprudence has provided an excellent pattern on this subject, for it has laid down many exceptions, some of which are contained in Articles 1413 to 1419.[6] (see Report of the Code Commission, pp. 140-141.) The exceptions in Articles 1411 and 1412 may be invoked by a party who is innocent or less guilty.

**ART. 1413. Interest paid in excess of the interest allowed by the usury laws may be recovered by the debtor, with interest thereon from the date of the payment.**

### Recovery of usurious interest.

Any rate of interest in excess of the maximum allowed under the Usury Law is usurious (see comments under Art. 1175.) and if paid, may be recovered together with interest thereon from the date of payment in a proper action for the same. (Art. 1413.)

A stipulation for the payment of usurious interest is void. The person paying the usurious interest can recover in an independent civil action not only the interest in excess of that allowed by the usury laws, but the *whole* interest paid. (Angel Jose Merchandising vs. Chelda Enterprises and D. Syjueco, 23 SCRA 119 [1968]; see Arts. 1175, 1957; Sec. 6, Usury Law.)

*Note:* By virtue of Central Bank Circular No. 905 (Dec. 10, 1982) issued by the Monetary Board under the authority granted to it by the Usury Law (Secs. 1-a, 4-a, and 4-b thereof.), the rate of interest and other charges on a loan or forebearance of money, goods or credit shall no longer be subject to any ceiling prescribed by the Usury Law.

[6]It would seem that the application of the principle of *pari delicto* is limited to void contracts that are illegal or unlawful. A party can always question the inexistence of a contract which lacks one or some of the elements essential for its validity.

**Recovery of principal of usurious loan.**

In a usurious loan transaction, the borrower is not relieved of the obligation to pay the principal of the loan on the assumption that a usurious contract, while void as to the interest, is valid as to the principal. (Lopez vs. El Hogar Filipino, 47 Phil. 249 [1925].) It has been held, however, by the Court of Appeals that a usurious loan is wholly null and void not only as to the principal but also as to the usurious interest because it is inconsistent with Articles 1352 and 1409, No. 1 of the Civil Code which provide that a contract whose cause is contrary to law or public policy is null and void and without effect whatsoever; and under Article 1411, both the debtor and the creditor have no action against each other. Hence, the creditor is not allowed to recover the principal of the loan. (Sebastian vs. Bautista, [CA] 59 O.G. No. 15, 314; People vs. Masangkay, [CA] 58 O.G. No. 17, 3565; Torres vs. Joco, [CA] 50 O.G. No. 10, 1580.)

Nevertheless, a usurious loan is not a complete nullity but merely a nullity with respect to the agreed interest. The rule is that the nullity or extinguishment of the accessory obligation does not carry with it that of the principal obligation. (see Arts. 1230, 1273, 1274, 1276.)

In a loan contract, the cause is, as to the borrower, the acquisition of the thing and as to the lender, the right to demand its return or its equivalent (Monte de Piedad vs. Javier, [CA] 36 O.G. 169.) and not exactly the stipulated interest. The interest in a contract of loan is merely an accidental stipulation and, therefore, its nullity cannot affect the contract of loan itself since the latter might be entered into without said stipulation. The prestation to pay the principal debt is separable from the accessory obligation to pay the interest thereon. (see Art. 1420.) The unpaid principal debt still stands and remains valid.

Therefore, the creditor is entitled to recover the principal of a usurious loan plus legal interest of 6% *per annum*[7] from the filing of the complaint pursuant to Article 2209. (Angel Jose Warehousing Co. vs. Chelda Enterprises, *supra*.)

**ART. 1414. When money is paid or property delivered for an illegal purpose, the contract may be repudiated by one of the parties before the purpose has been accomplished, or before any damage has been caused to a third person. In such case,**

[7]Now 12% *per annum* by virtue of C.B. Circ. No. 416. (see Art. 1175.)

**the courts may, if the public interest will thus be subserved, allow the party repudiating the contract to recover the money or property.**

### Recovery where contract for an illegal purpose.

"Article 1414 is one instance (the other is Art. 1416.) when the law allows recovery by one of the parties even though both of them have acted contrary to law." (Report of the Code Commission, p. 27.)

The following are the requisites for the application of this article:

(1) The contract is for an illegal purpose;

(2) The contract is repudiated before the purpose has been accomplished or before any damage has been caused to a third person; and

(3) The court considers that public interest will be subserved by allowing recovery.

The underlying reasons for the rule permitting a recovery when the agreement is still merely executory, are the encouragement of the abandonment of illegal agreements and the prevention of the violation of the law. (12 Am. Jur. 733.)

EXAMPLE:

In consideration of P10,000.00 paid by X to Y, the latter promised to hide Z, who is accused of murder. Before Y could hide Z, X changed his mind.

In this case, the court may allow X to recover the P10,000.00 given to Y.

**ART. 1415. Where one of the parties to an illegal contract is incapable of giving consent, the courts may, if the interest of justice so demands, allow recovery of money or property delivered by the incapacitated person.**

### Recovery by an incapacitated person.

This article is another exception to the *in pari delicto* rule in Articles 1411-1412. Recovery can be allowed if one of the parties is incapacitated and the interest of justice so demands.

It is not necessary that the illegal purpose has not been accomplished or that no damage has been caused to a third person. (see Art. 1414.)

EXAMPLE:

In the preceding example, if X is a minor or an insane person, the court may allow X to recover the money paid if the interest of justice so demands.

**ART. 1416. When the agreement is not illegal *per se* but is merely prohibited, and the prohibition by the law is designed for the protection of the plaintiff, he may, if public policy is thereby enhanced, recover what he has paid or delivered.**

### Recovery where contract not illegal per se.

Article 1416 is another exception to the rule that where both parties are *in pari delicto,* they will be left where they are without relief. Recovery is permitted provided:

(1) The agreement is not illegal *per se* but is merely prohibited;

(2) The prohibition is designed for the protection of the plaintiff; and

(3) Public policy would be enhanced by allowing the plaintiff to recover what he has paid or delivered.

### Prohibited sale of land.

Under the doctrine of *pari delicto,* the parties have no action against each other when they are both at fault. (Art. 1412[1].) The rule, however, has been interpreted as applicable only where the fault on both sides is, more or less, equivalent. It does not apply where one party is literate or intelligent and the other one is not. (Mangayao vs. Lasud, 11 SCRA 158 [1964].)

(1) A land sold in violation of the constitutional prohibition against the transfer of lands to aliens may be recovered. The public policy to conserve lands for the Filipinos would be defeated and its continued violation sanctioned if instead of setting the contract aside and ordering the restoration of the property, the general rule on *pari delicto* would be applied. And the parties will not be permitted to resort to another transaction for the purpose of disguising the transfer in violation of the Constitution.

Accordingly, it has been held that a contract whereby an alien is given not only a lease but also an option to buy a parcel of land by

virtue of which the Filipino owner cannot sell or otherwise dispose of her property, this to last for 50 years, is a virtual transfer of ownership and circumvents the constitutional ban against alien landholding. (Philippine Banking Corporation vs. Lui She, 21 SCRA 52 [1967] which qualifies the ruling laid down in Rellosa vs. Gaw Chee Hun, 93 Phil. 827 [1953] and subsequent similar cases.)

Incidentally, under Presidential Decree No. 471, the maximum period allowable for the duration of leases of private lands to aliens or alien-owned entities not qualified to acquire private lands under the Constitution is 25 years, renewable for another period of 25 years upon mutual agreement of both lessor and lessee.

(2) The principle of *pari delicto* is not applicable to a homestead which has been illegally sold within the prohibited period of five (5) years in violation of the homestead law. (Sec. 118, C.A. No. 141 [Public Land Act].) The policy of the law is to give land to a family for home and cultivation; consequently, the law allows the homesteader or free patent holder to reacquire the land even if it has been sold within the prohibited period. (Sec. 119, *Ibid.*; Heirs of E. Manlapat vs. Court of Appeals, 459 SCRA 412 [2005].)

The right to recover the same cannot be waived, and such sale being null and void, the action to recover does not prescribe. (Angeles vs. Court of Appeals, 102 Phil. 106 [1957].) It is not within the competence of any citizen to barter away what public policy by law seeks to preserve. (Gayotin vs. Tolentino, 79 SCRA 578 [1977].) This is without prejudice to such appropriate action as the Government may take should it find that violations of the public land laws were committed and sanctions are in order. (Philippine National Bank vs. De Los Reyes, 179 SCRA 619 [1989].)

But the seller should not be allowed to repurchase where his motive is only speculative and for profit for the same does not fall within the purpose, spirit and meaning of the law. (Vargas vs. Court of Appeals, 91 SCRA 195 [1979].)

(3) Section 122 of the Public Land Act has been amended by Section 11, Article XIV of the 1973 Constitution (now Sec. 3, Art. XII, 1987 Constitution.) by reducing to only 24 hectares (formerly 144) the maximum area of public land that can be acquired by an individual. It follows that such is also the maximum area of land acquired under the Act that could be transferred by any purchaser, patentee or

homesteader. A conveyance of public land, previously acquired from the Government, of more than 24 hectares is null and void. But it is not illegal *per se;* the constitutional limitation is *malum prohibitum* only, not *malum in se.* Hence, Article 1416 is applicable. (Guiang vs. Kintanar, 106 SCRA 49 [1981].)

ILLUSTRATIVE CASE:

*Conveyance of agricultural land by an illiterate, non-Christian is declared void by law if made without the approval of provincial governor.*

*Facts:* S sold to B an agricultural land. Both are non-Christian Subanos but S is illiterate and could not read and write while B is literate and could read and write.

Under the law, conveyances and encumbrances made by illiterate, non-Christians shall not be valid unless duly approved by the provincial governor or his representative. The sale was approved by said official only two (2) years after S filed a complaint for annulment, seeking to recover from B the land sold.

*Issues:* (1) Is the rule on *pari delicto* applicable?

(2) What is the effect of the approval of the contract by the provincial governor two (2) years after the complaint was filed?

*Held:* (1) No. S is not equally guilty. Conveyances by illiterate non-Christians are declared "null and void," not valid unless duly approved by the executive authority, as a matter of public policy. The evident purpose of the law is to forestall conflicts — some of which may affect peace and order — that often ensue in contracts made by or with non-Christians, when they have not clearly understood the import and effects thereof. The applicable rule is Article 416.

(2) The approval subsequently given by the provincial governor is irrelevant. S had already withdrawn his consent when he filed action in court to set the conveyance aside. (*Mangayao vs. Lasud, supra;* see Cunanan vs. Court of Appeals, 25 SCRA 263 [1968].)

### Contract illegal *per se* and contract against public policy distinguished.

An act or contract that is illegal *per se* is one that by universally recognized standards is inherently or by its very nature bad, improper, immoral or contrary to good conscience. On the other hand, what is contrary to public policy, like public interests, whether expressed in a Constitution or in any statute or official declaration of the duly

constituted authorities, or evinced from the situation or circumstances of the time concerned, is something dictated by the conditions obtaining within each country or nation.

For instance, in respect to the limitation and control of the disposition of lands of the public domain, every government in the world can have its own distinct policy suitable and peculiar to its internal interests, including the history, mores, customs, and traditions of the people thereof. The provisions of our Constitution and our laws covering such matter and the others relative to the conservation of our natural resources exclusively for us, Filipinos, are easily distinguishable from those of the Constitution and laws of the United States, Russia, England, Singapore, Malaysia, etc. Thus, the juridical concept of what is illegal *per se* cannot be necessarily equated with what is contrary to public policy in all instances. (Guiang vs. Kintanar, 106 SCRA 47 [1981].)

**ART. 1417. When the price of any article or commodity is determined by statute, or by authority of law, any person paying any amount in excess of the maximum price allowed may recover such excess.**

### Recovery of amount paid in excess of ceiling price.

A statute fixing the maximum price of any article or commodity is usually known as the *ceiling law.* It can also be determined by authority of law, as by Executive Order of the President. Its purpose is to curb the evils of profiteering or blackmarketing.

**ART. 1418. When the law fixes, or authorizes the fixing of the maximum number of hours of labor, and a contract is entered into whereby a laborer undertakes to work longer than the maximum thus fixed, he may demand additional compensation for service rendered beyond the time limit.**

### Recovery of additional compensation for service rendered beyond time limit.

Presidential Decree No. 442, as amended, otherwise known as the Labor Code, sets forth that the normal hours of work of any employee shall not exceed eight (8) hours a day.

The Labor Code applies to employees in all establishments and undertakings, whether for profit or not, but not to: (1) government

employees; (2) managerial employees; (3) field personnel; (4) members of the family of the employer who are dependent upon him for support; (5) domestic helpers; (6) persons in the personal service of another; and (7) workers who are paid by results. (see Arts. 82, 83 thereof.)

**ART. 1419. When the law sets, or authorizes the setting of a minimum wage for laborers, and a contract is agreed upon by which a laborer accepts a lower wage, he shall be entitled to recover the deficiency.**

### Recovery of amount of wage less than minimum fixed.

If an employee or worker receives less than the minimum wage rate, he can still recover the deficiency with legal interest (see Art. 128, Pres. Decree No. 442, as amended.), and the employer shall be criminally liable. (see Arts. 278, 279, *Ibid.*)

**ART. 1420. In case of a divisible contract, if the illegal terms can be separated from the legal ones, the latter may be enforced.**

### Effect of illegality where contract indivisible/divisible.

(1) Where the consideration is entire and single, the contract is indivisible (or entire) so that if part of such consideration is illegal, the whole contract is void and unenforceable.

(2) Where the contract is divisible (or severable) that is, the consideration is made up of several parts, and the illegal ones can be separated from the legal portions, without doing violence to the intention of the parties, the latter may be enforced. This rule, however, is subject to the contrary intention of the parties. (see Borromeo vs. Court of Appeals, 47 SCRA 65 [1972]; Litonjua vs. L & R Corporation, 328 SCRA 796 [2000].)

EXAMPLES:

(1) S sold to B his car and shabu, a prohibited drug, for P200,000.00.

The contract is wholly void and unenforceable because there is only one consideration for both the car and the shabu. However, if the price

of the car is P150,000.00 and that for the drug is P50,000.00, the contract, being divisible, is valid as to the sale of the car.

(2) D executed a promissory note in favor of C for money won by C in two (2) games played on two (2) occasions, *monte,* a prohibited game, and *surro* which is not prohibited.

The burden of proof is upon C to show what part of the amount is legal, *i.e.*, won at the game of *surro*; otherwise, the entire note cannot be enforced. (see Lichauco vs. Martinez, 6 Phil. 594 [1906]; Art. 1353.)

(3) D borrowed P10,000.00 from C with stipulation of usurious interest.

In this case, the prestation of D to pay the principal debt (P10,000.00), which is the cause of the contract (see Art. 1350.), is not illegal. The illegality lies only as to the prestation to pay the stipulated interest. Hence, being separable, the latter only should be deemed wholly void, since it is the only one that is illegal (see Angel Jose Warehousing Co., Inc. vs. Chelda Enterprises and Syueco, 23 SCRA 119 [1968]; Private Development Corp. of the Phils. vs. Intermediate Appellate Court, 213 SCRA 282 [1992].), so that the loan becomes one without a stipulation as to payment of interest. The borrower is still liable to pay the principal debt, otherwise he would unjustly enrich himself at the expense of the principal. (Spouses Puerto vs. Court of Appeals, 383 SCRA 185 [2002].)

*Note:* Loan or forbearance of money, etc. is no longer subject to any ceiling prescribed by the Usury Law. (see Art. 1175.)

ILLUSTRATIVE CASE:

*Vendee of land and improvements thereon would not have entered into the contract of sale except to acquire all the properties.*

*Facts:* S sold to B a parcel of land belonging to S and Y, in co-ownership, and the improvements thereon belonging to Z. Y and Z were not parties to the sale. Both S and B acted in bad faith. B would not have entered into the transaction except to acquire all the properties purchased by him.

Two actions were commenced, the first was by Z for annulment of the sale, and the second by Y for rescission.

*Issue:* Is the sale entirely null and void, or with respect only to the shares, rights and interests of Y and Z?

*Held:* The sale is entirely void as it purports to cede properties of which the vendor is not the only owner and the prestation involved is indivisible, and, therefore, incapable of partial annulment. Although the bad faith of one party neutralizes that of the other and hence, as between

themselves, their rights would be as if both of them had acted in good faith at the time of the transaction, this legal fiction of B's good faith ceased when the complaint against him was filed. Hence, B should be held liable for the rents thereafter on the property. *(Mindanao Academy, Inc. vs. Yap, 13 SCRA 190 [1965].)*

### Divisible contract distinguished from divisible obligation.

It must be noted that Article 1420 speaks of a divisible contract and not of a divisible obligation. (see Arts. 1225, 1183.)

The test of the former is the divisibility of its cause while the latter, its susceptibility of partial fulfillment. The former, therefore, refers to the cause, while the latter, to the prestation or object. (see Mindanao Academy, Inc. vs. Yap, *supra;* Estogue vs. Pajimula, 24 SCRA 59 [1968].)

EXAMPLE:

S paid P1,000.00 as annual subscription to a weekly magazine to be delivered every week. The contract is indivisible but the obligation of the publisher is divisible.

If the agreement is that the publisher will deliver the magazine every week and S will pay P25.00 upon such delivery, the contract is divisible. The obligations of the parties are likewise divisible.

**ART. 1421. The defense of illegality of contracts is not available to third persons whose interests are not directly affected.**

### Persons entitled to raise defense of illegality or nullity.

In voidable (Art. 1397.) and unenforceable contracts (Art. 1408.), third persons are not allowed to bring an action to annul or to assail, as the case may be, said contracts.

If the contract is illegal or void, however, even a third person may avail of the defense of illegality or set up its illegality as long as his interest is directly affected by the contract. (see Estanislao vs. GSIS, 60 SCRA 33 [1974]; Arsenal vs. Intermediate Appellate Court, 143 SCRA 40 [1980]; Chavez vs. Presidential Commission on Good Government, 307 SCRA 394 [1999]; see Art. 1177.)

EXAMPLE:

H, husband, sold her parcel of land to W, his wife. Under the law, husband and wife cannot sell property to each other (Art. 1490.) and such sale is, therefore, illegal and void. (Art. 1409[7].) The purpose of the prohibition is to protect third persons who, relying upon supposed property of either spouse, enter into a contract with either of them only to find out that the property relied upon was transferred to the other spouse.

Under Article 1421, if C, a third person, became a creditor of H before the transaction, he can question the sale for the reason that his right or interest is directly affected. However, if he became a creditor after the transfer, the defense of illegality is not available to him. (see Cook vs. McMicking, 27 Phil. 10 [1914].)

ILLUSTRATIVE CASE:

*Homestead sold by grantee within the prohibited period, was subsequently sold again to another.*

*Facts*: In violation of the Public Land Act, S sold to B within the 5-year prohibited period a homestead land. Under the Act, the sale was void. Subsequently, S sold the same property to T.

*Issue:* Can T avail of the prohibition in the law?

*Held:* Yes. In this case it is precisely T's interest in the disputed land which is in question. *(Arsenal vs. Intermediate Appellate Court, supra.)*

**ART. 1422. A contract which is the direct result of a previous illegal contract, is also void and inexistent.**

## Void contract cannot be novated.

This provision is based on the requisites of a valid novation. (see comments and examples under Art. 1298.) An illegal contract is void and inexistent and cannot, therefore, give rise to a valid contract.

For example, a contract of repurchase is dependent on the validity of the contract of sale. If the latter is itself void because the seller is not the owner, the former is also void because it presupposes a valid contract of sale between the same parties. One can repurchase only what he has previously sold. (Nool vs. Court of Appeals, 276 SCRA 149 [1997].)

ILLUSTRATIVE CASE:

*Renewal of management contract was made possible through transfer of shares of stocks which was null and void.*

*Facts:* AR, through persons fronting for him, acquired from ER 60% equity of ER, Inc. The purpose of AR was to be able to transact business with the government through the nominal owners. Under the Anti-Graft and Corrupt Practices Act (Sec. 5, R.A. No. 3019.), AR, by reason of his relationship with then President of the Philippines (being brothers-in-law), was prohibited from intervening directly or indirectly in any transaction or business with the government.

On the part of ER, his purpose in transferring the shares of stock to AR was to be unduly favored, through the influence of AR, with the renewal of the management contract with the Philippine Ports Authority (PPA) to operate the arrastic service in all the ports at South Harbor, Manila. Thus, it came to pass that ER was able to secure a renewal of the contract.

*Issue:* Is the management contract valid?

*Held:* No. The contract is the direct result of a previous illegal contract (*i.e.*, the transfer of the shares of stock) and, therefore, is itself null and void under Article 1422. *(E. Razon, Inc. vs. Philippine Ports Authority, 151 SCRA 233 [1987].)*

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# TITLE III

# NATURAL OBLIGATIONS

*(Arts. 1423-1430.)*

**ART. 1423. Obligations are civil or natural. Civil obligations give a right of action to compel their performance. Natural obligations, not being based on positive law but on equity and natural law, do not grant a right of action to enforce their performance, but after voluntary fulfillment by the obligor, they authorize the retention of what has been delivered or rendered by reason thereof. Some natural obligations are set forth in the following articles.**

### Concept of natural obligations.

The above article defines natural obligations.

According to the Code Commission:

"Natural obligations originated in the Roman law where they grew in importance in order to temper with equity and justice the severity of the *jus civile.* In that ancient system of law, there were two kinds of obligations: the civil and the natural. The latter could not be enforced by a civil action but it had certain juridical consequences.

In the old Spanish law, there were many instances of natural obligations, among them being the cases of incapacity of one of the contracting parties, and where a contract could not be sued upon because it was not in the form required by law." (Report of the Code Commission, p. 56.)

### Reasons for inclusion of provisions on natural obligations.

According to the Code Commission:

"In all the specific cases of natural obligations recognized by

the Civil Code, there is a moral but not a legal duty to perform or pay, but the person thus performing or paying feels that in good conscience he should comply with his undertaking which is based on moral grounds. Why should the law permit him to change his mind, and recover what he has delivered or paid? Is it not wiser and more just that the law should compel him to abide by his honor and conscience? Equity, morality, natural justice — these are, after all, the abiding foundations of all positive law. A broad policy justifies a legal principle that would encourage persons to fulfill their moral obligations.

Furthermore, when the question is viewed from the side of the payee, the incorporation of natural obligations into the legal system becomes imperative. Under the laws in force, the payee is obliged to return the amount received by him because the payor was not legally bound to make the payment. But the payee knows that by all considerations of right and justice he ought to keep what has been delivered to him. He is, therefore, dissatisfied over the law, which deprives him of that which in honor and fair dealing ought to pertain to him. Is it advisable for the State thus to give grounds to the citizens to be justly disappointed?

To recapitulate: because they rest upon morality and because they are recognized in some leading civil codes, natural obligations should again become part and parcel of Philippine Law." (*Ibid.*, pp. 58-59.)

**Civil obligations and natural obligations distinguished.**

Article 1423 gives the distinctions between civil obligations and natural obligations, *viz.:*

(1) Civil obligations arise from law, contracts, quasi-contracts, delicts, and quasi-delicts (Art. 1157.), while natural obligations are based not on positive law but on equity and natural law; and

(2) Civil obligations give a right of action in courts of justice to compel their fulfillment or performance (Art. 1156.), while natural obligations do not grant such right of action to enforce their performance.

**Enforceability of natural obligations.**

Natural obligations are not cognizable by the courts unless there has been voluntary fulfillment in which case, the court may order the retention of what has been delivered or rendered by reason thereof. (Ansay vs. Board of Directors of National Dev. Co., 107 Phil. 997 [1960].) Fulfillment or performance is voluntary when the obligor knew that the obligation cannot legally be enforced.

Payment by mistake, the obligor believing the obligation to be a civil one, may be recovered on the principle of *solutio indebiti.* (see Art. 2154.)

ILLUSTRATIVE CASE:

*Mortgagor failed to repurchase mortgaged property after period of redemption had expired.*

*Facts:* B (bank-mortgagee) foreclosed the mortgage and bought the property at the foreclosure sale on July 21, 1972. D (mortgagor) failed to redeem the property before the expiration of the one-year period of redemption on August 21, 1973 although she was advised on August 8, 1973 of his right.

On September 24, 1973, B gave D up to October 31, 1973, within which to repurchase (not redeem since period of redemption had expired) but it was only on November 5, 1973 that D delivered the repurchase price. B sold the property to another.

*Issue:* Is B bound to reconvey the property to D?

*Held:* No. There was no binding agreement for its repurchase. Even on the assumption that B should be bound, D had no cause of action because she did not repurchase the property on October 31, 1973. Justice is done according to law. As a rule, equity follows the law. There may be a moral obligation, often regarded as an equitable consideration (meaning compassion), but if there is no enforceable legal duty, the action must fail although the disadvantaged party deserves commiseration or sympathy. *(Rural Bank of Parañaque, Inc. vs. Remolado, 135 SCRA 409 [1985].)*

**Enumeration not exclusive.**

Note that Article 1423 says "Some natural obligations, x x x." This indicates that the enumeration in the Code is not exclusive. Thus, if the borrower pays interest agreed upon orally, the provisions on natural obligations apply. (see Art. 1960.) Under the law, "no interest shall be

due unless it has been expressly stipulated in writing." (Art. 1956; see Art. 1175.)

**ART. 1424. When a right to sue upon a civil obligation has lapsed by extinctive prescription, the obligor who voluntarily performs the contract cannot recover what he has delivered or the value of the service he has rendered.**

### Performance after civil obligation has prescribed.

*By prescription* (acquisitive), one acquires ownership and other real rights through the lapse of time in the manner and under the conditions laid down by law. In the same way, rights and actions are lost by prescription (extinctive). (Art. 1106; see Art. 1218.)

EXAMPLE:

D owes C the sum of P5,000.00 under a written contract. After 10 years, the debt of D prescribes for failure of C to file the necessary action for the recovery of the same. (Art. 1144[1].)

If D, knowing of the prescription, voluntarily pays C, he cannot recover anymore what he has paid. He has the moral duty to pay his debt.

**ART. 1425. When without the knowledge or against the will of the debtor, a third person pays a debt which the obligor is not legally bound to pay because the action thereon has prescribed, but the debtor later voluntarily reimburses the third person, the obligor cannot recover what he has paid.**

### Reimbursement of third person for debt that has prescribed.

If a third person pays the prescribed debt of the debtor without his knowledge or against his will, the latter is not legally bound to pay him. (see Art. 1236, par. 2.) But the debtor cannot recover what he has paid, in case he voluntarily reimburses the third person.

EXAMPLE:

In the above example, if T pays C after the debt has prescribed without the knowledge or consent of D, but D nevertheless reimburses T, D cannot recover what he has paid.

**ART. 1426. When a minor between eighteen and twenty-one years of age who has entered into a contract without the consent of the parent or guardian, after the annulment of the contract voluntarily returns the whole thing or price received, notwithstanding the fact that he has not been benefited thereby, there is no right to demand the thing or price thus returned.**

### Restitution by minor after annulment of contract.

When a contract is annulled, a minor is not obliged to make any restitution except insofar as he has been benefited by the thing or price received by him. (Art. 1399.) However, should he voluntarily return the thing or price received although he has not been benefited thereby, he cannot recover what he has returned.

Take note that this article applies only if the minor who has entered into a contract without the consent of his parent or guardian is between 18 and 21 years of age.[1] The law considers that at such age, a minor has already a conscious idea of what is morally just or unjust.

EXAMPLE:

S, a minor 18 years old, sold for P100,000.00 his car to B without securing the consent of his parents. He lost P20,000.00 to a pickpocket although he was able to deposit the P80,000.00 in a bank.

If the contract is annulled, S is obliged to return only P80,000.00. However, he has the natural obligation to return P100,000.00. If he voluntarily returns the whole amount, there is no right to demand the same.

**ART. 1427. When a minor between eighteen and twenty-one years of age, who has entered into a contract without the consent of the parent or guardian, voluntarily pays a sum of money or delivers a fungible thing in fulfillment of the obligation, there shall be no right to recover the same from the obligee who has spent or consumed it in good faith. (1160a)**

### Delivery by minor of money or fungible thing in fulfillment of obligation.

By the decree of annulment, the parties, as a general rule, are obliged to make mutual restitution. (Art. 1398.) However, the obligee

[1] Art. 234. Emancipation takes place by the attainment of majority. Unless otherwise provided, majority commences at the age of eighteen years. x x x. (Family Code.)

who has spent or consumed in good faith the money or consumable[2] thing voluntarily paid or delivered by the minor, is not bound to make restitution.

Although Article 1427 speaks of "fungible thing," nevertheless it may also apply to things that are non-consumable when they have been lost without fault of the obligee or in case of alienation by him to a third person who did not act in bad faith. The obligee shall be liable for damages if he is guilty of fault or bad faith at the time of spending or consumption.

Note again that this article is applicable only if the minor is between 18 and 21 years of age.

**ART. 1428. When, after an action to enforce a civil obligation has failed, the defendant voluntarily performs the obligation, he cannot demand the return of what he has delivered or the payment of the value of the service he has rendered.**

### Performance after action to enforce civil obligation has failed.

This article contemplates a situation where a debtor, who has failed to pay his obligation, is sued by the creditor and instead of losing the case, he has won it. If, notwithstanding this fact, the debtor voluntarily performs his obligation, he cannot demand the return of what he has delivered or the payment of the value of the service he has rendered. He must be deemed to have considered it his moral duty to fulfill his obligation.

**ART. 1429. When a testate or intestate heir voluntarily pays a debt of the decedent exceeding the value of the property which he received by will or by the law of intestacy from the estate of the deceased, the payment is valid and cannot be rescinded by the payer.**

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[2]Art. 418. "Movable property is either consumable or non-consumable. To the first class belong those movables which cannot be used in a manner appropriate to their nature without their being consumed; to the second class belong all the others." (337)

The present Code has discarded the old classification of movable property into fungible and non-fungible (see Art. 334, old Civil Code.) although the change in classification is in name only as the definition of fungible goods under the old Code is precisely that of consumable goods. Hence, the word "fungible" in Article 1427 really means "consumable."

**Payment by heir of debt exceeding value of property inherited.**

The heir is not personally liable beyond the value of the property he received from the decedent. (Art. 1311, par. 1.) But if he voluntarily pays the difference, the payment is valid and cannot be rescinded by him. An heir has a moral duty to perform or pay obligations legally contracted by his dead relatives.

> **ART. 1430. When a will is declared void because it has not been executed in accordance with the formalities required by law, but one of the intestate heirs, after the settlement of the debts of the deceased, pays a legacy in compliance with a clause in the defective will, the payment is effective and irrevocable.**

**Payment of legacy after will has been declared void.**

*Legacy* is the act of disposition by the testator in separating from the inheritance for definite purposes, things, rights, or a definite portion of his property. It may be viewed also as that same portion, or those things or special rights, which the testator separates from his inheritance for a definite purpose. (6 Manresa 654.) The purpose of a legacy is to reward friends, servants and others for services they have rendered, to give alms, etc.

If a will is disallowed for non-compliance with the formalities prescribed by law (see Arts. 805, 839[1].), the legacy made in the will would also be void. The effect is the same as if the deceased had died without a will, and, therefore, the intestate heir is not legally required to pay the legacy. If, however, he still pays the legacy, the payment is effective and irrevocable, subject to the rights of the creditors of the deceased. Since, it was the intention of the testator to give the legacy, it is the moral duty of the heir to carry it out.

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# TITLE IV

# ESTOPPEL (N)

*(Arts. 1431-1439.)*

**ART. 1431. Through estoppel an admission or representation is rendered conclusive upon the person making it, and cannot be denied or disproved as against the person relying thereon.**

**ART. 1432. The principles of estoppel are hereby adopted insofar as they are not in conflict with the provisions of this Code, the Code of Commerce, the Rules of Court and special laws.**

## Concept of estoppel.

Generally speaking, *estoppel*[1] is a bar which precludes a person from denying or asserting anything to the contrary of that which has, in contemplation of law, been established as the truth, either by the acts of judicial or legislative officers, or by his acts, representations, or admissions, either express or implied. (see 28 Am. Jur. 2d. 599-600.)

## Matters to which term has been applied.

The term is often held to apply only to matters of fact but cases are not wanting in which one is said to be estopped to set up a right under the Constitution, or to take inconsistent legal positions, or to deny that

[1]Rule 131 of the Rules of Court contains a provision concerning estoppel which is more or less the same as that stated in Article 1431, to wit:

"Sec. 2. *Conclusive Presumptions*. — The following are instances of conclusive presumptions:

(a) Whenever a party has, by his own declaration, act, or omission, intentionally and deliberately led another to believe a particular thing true, and to act upon such belief, he cannot, in any litigation arising out of such declaration, act or omission, be permitted to falsify it. x x x."

he is an officer *de jure* in a criminal prosecution for acts done as such officer.

It is very difficult, therefore, to frame any formal definition which will cover or include all the matters to which the term has been applied by the courts. (*Ibid.*, p. 599.)

**Source of provisions on estoppel.**

Estoppel is an important branch of American law. It is a source of many rules which work out justice between the parties, through the operation of the principle embodied in Article 1431.

In this Title, some of the frequent situations where the principle is applicable are set forth. (see Report of the Code Commission, p. 59.)

**Principles of estoppel adopted.**

By virtue of Article 1432, the principles of estoppel are adopted insofar as they are not in conflict with the provisions of existing laws. Implementing Article 1431 in Section 2(a) of Rule 131 of the Rules of Court which provides: "Whenever a party has, by his own declaration, act, or omission, intentionally and deliberately led another to believe a particular thing true, and to act upon such belief, he cannot, in any litigation arising out of such declaration, act, or omission, be permitted to falsify it."

By its incorporation in the Civil Code, estoppel in our jurisdiction has become an equitable defense that is both substantive and remedial. Its successful invocation can, therefore, bar a right and not merely its equitable enforcement. (Phil. Bank of Communications vs. Court of Appeals, 289 SCRA 178 [1998].)

Article 1432 incorporates a considerable portion of the law of estoppel as known in American jurisprudence. According to the Code Commission, the principle "will enrich Philippine law and afford solutions to many questions which are not foreseen in our legislation. It is true that in the present [old] Civil Code there are a number of articles whose underlying principle is that of estoppel, but the [old] Code now in force does not definitely recognize estoppel as a separate and distinct branch of the legal system." *(Ibid.)*

**Doctrine of equitable estoppel not new.**

The principle of estoppel expressed in statutory form for the first time in our Civil Code is thus not really an innovation.

It has its origin in equity and, being based on moral right and natural justice, finds applicability wherever and whenever the special circumstances of a case so demand. In fact, the doctrine has been applied by the Supreme Court even before the effectivity of the new Civil Code in the case of *Llacer vs. Muñoz* (12 Phil. 328.) as long ago as 1908. (see Mirasol vs. Municipality of Tarlac, 43 Phil. 601 [1922]; Castrillo vs. Court of Appeals, 10 SCRA 249 [1964].)

**Basis and purpose of the doctrine.**

(1) The doctrine of equitable estoppel is based upon the grounds of public policy, fair dealing, good faith, and justice. (Phil. National Bank vs. Court of Appeals, 94 SCRA 357 [1979].) "It has its foundation in a wise and salutory policy and without it society could not go on." (Daniel vs. Tearney, 102 US 415.) It is the ground of estoppel that to permit one to prove as false, representations on which another has acted would be contrary to equity and good conscience. (Nesbilt vs. Erie Coach Co., 416 Pa. 89.)

It is based on the application of the Golden Rule to the everyday affairs of man. It requires that one should do unto others as, in equity and good conscience, he would have them do unto him if their positions were reversed. (McNeedly vs. Walters, 189 SE 114.)

(2) Its purpose is to forbid one to speak against his own act, representations, or commitments to the injury of one who has relied on them. It concludes the truth in order to prevent fraud and falsehood and imposes silence on a party only when in conscience and honesty he should not be allowed to speak. (28 Am. Jur. 2d. 629-630.)

(3) The principle of estoppel under Article 1431 as only of supplicatory application. It is designed to aid the law in the administration of justice where without its aid injustice might result. (Phil. National Bank vs. Court of Appeals, *supra*.) The real office of the equitable norm of estoppel is limited to supplying deficiency in the law, but should not supplant positive law. (Republic vs. Court of Appeals, 301 SCRA 366 [1999]; Republic vs. Sandiganbayan, 226 SCRA 14 [1993].)

**Applicability of the doctrine.**

Estoppel is not understood to be a principle that, as a rule, should prevalently apply but as a mere exception from the standard legal norms of general application that can be invoked only in highly exceptional

and justifiable cases. (La Naval Drug Corp. vs. Court of Appeals, 236 SCRA 78 [1994]; Consumido vs. Ros, 528 SCRA 696 [2007].) Like laches *(infra.)*, it must be intentional and unequivocal, for when misapplied, it can easily become a most convenient and effective means of injustice. (Arcelona vs. Court of Appeals, 280 SCRA 20 [1997]; Santos vs. Heirs of Jose P. Mariano, 344 SCRA 284 [2000]; Tanay Recreation Center & Dev. Corp. vs. Fausto, 455 SCRA 436 [2005]; Rockland Construction Co., Inc. vs. Mid-Pasig Land Dev. Corp. 543 SCRA 596 [2008].)

(1) The doctrine of equitable estoppel is one of fundamental justice. As it had its origin in equity, which broadly defined, is justice accending to natural law and right its applicability depends to a large extent, upon the circumstances of each particular case. (Phil. Air Lines Employees Association vs. Phil. Air Lines, Inc., 70 SCRA 244 [1976]; Arcelonia vs. Court of Appeals, *supra.*)

The doctrine cannot arise against a party except when justice to the rights of others demands it and when to refuse it would be inequitable. Hence, in determining its application, the counter equities of the parties are entitled to due consideration, and therefore, it is to *be applied or denied as the equities between the parties may preponderate*. (28 Am. Jur. 2d. 631.) Under the doctrine, when one of two innocent persons, each guiltless of any intentional or moral wrong, must suffer a loss, it must be borne by one whose erroneous conduct either by commission or omission, was the cause of the injury. (Metropolitan Waterworks and Sewerage System vs. Court of Appeals, 143 SCRA 20 [2006]; Trust Co. vs. Cabilzo, 510 SCRA 259 [2006].)

ILLUSTRATIVE CASES:

1. *Mortgagee (bank) reneged on its commitment to mortgagor and subsequently to his heir, made after failure of mortgagor to reacquire the mortgaged property foreclosed by it, to allow the redemption of the property by selling instead the property to another.*

*Facts:* In 1932, D mortgaged a land in favor of C (Bank) to secure a loan of P500.00. The day following the issuance of a certificate of sale in favor of C after the foreclosure sale, the latter executed a "Promesa de Venta" in favor of D, giving the latter eight (8) years within which to reacquire his land. In 1948, or approximately seven (7) years after the default of D, H, heir of D, offered to pay the last two (2) unpaid amortizations.

On the ground that the "Promesa de Venta" was executed by C in favor of D, C's branch manager suggested to H to file on action in court

for declaration of heirship, which H did, and H was declared the sole heir of D. C's branch manager informed H that as soon as H "could cause full payment of above account (P535.45), they shall cause the release of the mortgage."

Relying on this commitment, H offered to buy the land this time for P3,000.00, later increased to P8,000.00 because the manager asked him to increase the price offered. C later sold the land to T for P13,500.00 because H could not equal the offer of T.

*Issue:* Is C liable to H for damages?

*Held:* Yes. On equitable principles, particularly on the ground of estoppel, the case must be resolved against C. On the facts, the clear intendment of C was to allow D to reacquire ownership of the property. Also, C never disturbed D's and H's possession and it did not register the property until 1958, or 24 years after the certificate of title was issued in its favor. H justifiably and reasonably relied upon the assurance of C's manager that he would be allowed to pay the remaining obligation of D and he acted on that basis.

Even fair dealing alone would have required C to abide by its representations, but it did not. Clearly, the equities of the case are with H. *(Phil. National Bank vs. Court of Appeals, 94 SCRA 357 [1979].)*

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2. *Seller did not object to construction of electric substation by buyer on property within subdivision for "residential purposes" only.*

*Facts:* S sold to B (Meralco) lots subject to the restriction that only construction exclusively for residential purposes shall be built. It appears that S did not object to the construction of an electric substation by B, but merely asked in a letter for "technical assurance that your electric substation is not dangerous to neighbors nor would they be a nuisance."

S sought the cancellation of the sale for violation of the restriction.

*Issue:* Is S guilty of estoppel?

*Held:* Yes, for there was no timely objection on his part to the establishment of the substation as being not for residential purposes. On the contrary, by his letter, S did not consider it as violative of the restriction. "Acts done by the parties to a contract in the course of its performance are admissible in evidence upon the question of its meaning as being their own contemporaneous interpretation of its terms." *(Manila Electric Company vs. Court of Appeals, 114 SCRA 173 [1982].)*

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3. *An American granted absolute divorce in his country is asserting his rights over conjugal property allegedly owned by him and former Filipina wife.*

*Facts:* A divorce decree was obtained from a U.S. Court by H, American husband of F, a Filipina. While Philippine nationals are covered by the policy against absolute divorces,[2] aliens may obtain divorces abroad, which may be recognized in the Philippines, provided they are valid according to their national law.

Before the U.S. Court, H represented that they had no community of property. H contends that divorce is not valid in the Philippines, the same being contrary to local law and public policy.

*Issue:* Does H have the standing to sue as F's husband, entitled to exercise control over conjugal assets?

*Held:* No. He is estopped by his own representation before said court from asserting his right over the alleged conjugal property. To maintain that under our laws, F has to be considered still married to H and still subject to a wife's obligations cannot be just. F should not be discriminated in her own country if the ends of justice are to be served. *(Van Dorn vs. Romillo, Jr., 139 SCRA 139 [1985].)*

(2) It is available only in defense of a legal or equitable right or claim made in good faith and can never be asserted to uphold crime, fraud, injustice, or wrong of any character. Estoppel is to *be applied against wrongdoers, not the victim of a wrong.* (28 Am. Jur. 2d. 631-632.)

(3) The doctrine of estoppel *does not apply against the government suing in its capacity as sovereign or asserting government rights.*

(a) The well-entrenched principle is that the State or government is never estopped by the mistakes or errors, negligence or omission on the part of its officials or agents (Republic vs. Go Bon Lee, 111 Phil. 805 [1961]; Zamora vs. Court of Appeals, 36 SCRA 77 [1970]; Luciano vs. Estrella, 34 SCRA 769 [1970]; Sy vs. Central Bank of the Phil., 72 SCRA 570 [1976]; Republic vs. Intermediate Appellate Court, 209 SCRA 90 [1992]; Phil. National Oil Co. vs. Court of Appeals, 457 SCRA 32 [2005].), or wrong construction of the law (Comm. of Internal Revenue vs. Court of Appeals, 261 SCRA 236 [1997].), or unauthorized or illegal acts of public of-

[2]Art. 15. Laws relating to family rights and duties, or to the status, condition and legal capacity of persons are binding upon citizens of the Philippines, even though living abroad. (1a)

ficials (Republic vs. Heirs of Felix Caballero, 79 SCRA 177 [1977].), particularly in matters involving taxes, and the erroneous application and enforcement of the law by public officers do not preclude subsequent correct application of the statute. (Philippine Basketball Association vs. Court of Appeals, 337 SCRA 358 [2000].)

Thus, errors of tax officials do not bind the government or prejudice its right to collect the taxes legally due from taxpayers. (Collector of Internal Revenue vs. MacGrath, 111 Phil. 222 [1961].) For upon taxation depends the government's ability to serve the people for whose benefits taxes are collected. To safeguard such interest, neglect or omission of government officials entrusted with the collection of taxes should not be allowed to bring harm or detriment to the people, in the same manner as private persons may be made to suffer individually on account of his own negligence, the presumption being that they take good care of their personal affairs. This should not hold true to government officials with respect to matters not of their own personal concern. This is the philosophy behind the government's exception, as a general rule, from the operation of the principle of estoppel. (Vera vs. Fernandez, 89 SCRA 199 [1979]; Atlas Consolidated Mining & Dev. Corp. vs. Comm. of Internal Revenue, 102 SCRA 246 [1981].)

(b) And if through misapprehension of a law an officer has erroneously executed it for a long time, the error may be corrected when the true construction is ascertained. (PLDT Co. vs. Collector of Internal Revenue, 90 Phil. 674 [1953].) The erroneous application and enforcement of the law by public officers do not bar subsequent correct application by the State. (Cruz, Jr. vs. Court of Appeals, 194 SCRA 145 [1991].)

But while the State is immune from estoppel, *this concept is understood to refer to acts and mistakes of its officials* especially those which are irregular. Although the State's right to recover ill-gotten wealth is not vulnerable to estoppel under the Constitution (Sec. 15, Art. XI thereof.), it is *non sequitur* to suggest that a contract (compromise) freely and in good faith executed between the parties thereto is susceptible to disturbance *ad infinitum*. Since a compromise has upon the parties and their successors-in-interest the effect of *res judicata* (Art. 2037.), it can only be rescinded, on the ground of vitiated consent and this is true even if the compromise turns out to be unsatisfactory to either of the parties.

The general rule is that the State cannot be put in estoppel by the mistakes or errors, or negligent acts of its officers or agents. "Nevertheless the government must not be allowed to deal dishonorably or capriciously with its citizens and must not play an ignoble part or do a shabby thing; and subject to limitations x x x, the doctrine of equitable estoppel may be invoked against public authorities as well as against private individuals."

Thus, the government's prolonged inaction for nearly 20 years (starting from the issuance of titles in 1966 up to the filing of the complaint in 1985), whereby it failed to correct and recover the alleged increase in the land area of a private party, strongly militates against its cause as it is tantamount to laches. It is only fair and reasonable to apply the equitable principle of estoppel by laches against the government to avoid an injustice to innocent purchasers for value. (Republic vs. Court of Appeals, 301 SCRA 360 [1999]; see Barstowe Phil. Corp. vs. Republic, 519 SCRA 148 [2007].) Thus, while the general rule is that an action to recover lands of the public domain is imprescriptible, said right can be barred by laches. Section 32 of Pres. Decree No. 1592 (Property Registration Decree) recognizes the rights of an innocent purchaser for value over and above the interests of the government. (Estate of J.S. Yujuico vs. Republic, 537 SCRA 513 [2007].) The principle must give way to exceptions based on and in keeping with the interest of justice and fairness. (Comm. of Internal Revenue vs. Benguet Corporation, 463 SCRA 28 [2005].)

(4) It *cannot be applied as against a municipal corporation to validate a contract which it has no power to make*, and this is true although it has accepted the benefits thereof, for to apply the doctrine in such a case would be to enable it to do indirectly what it cannot do directly. Thus, where a city sold public property (*i.e.*, reclaimed portion of the old Luneta), it is not estopped from later questioning the sale. (Manila Lodge No. 763, Benevolent and Protective Order of the Elks, Inc. vs. Court of Appeals, 73 SCRA 162 [1976]; Pechueco Sons Co. vs. Prov. Board of Antique, 31 SCRA 320 [1970].)

(5) Estoppel *cannot be predicated on an illegal act.* It is generally considered that as between the parties to a contract, validity cannot be given to it by estoppel if it is prohibited by law or is against public policy. (Prudential Bank vs. Panis, 153 SCRA 390 [1987]; Eugenio vs. Perdido, 97 Phil. 41 [1955]; Gorospe and Sebastian vs. Gochangco, 106 Phil. 425 [1959]; Baltazar vs. Lingayen Gulf Electric Power Co., 14

SCRA 522 [1965]; Sy vs. Central Bank of the Phil., 70 SCRA 570 [1976]; Republic vs. Go Bon Lee, 111 Phil. 305 [1961]; Auyong Hian vs. Court of Tax Appeals, 59 SCRA 110 [1974]; Duano vs. Court of Appeals, 398 SCRA 525 [2003].)

(a) Thus, it has been held that the unilateral adoption by a company of an irregular wage formula being an act against public policy, the doctrine of estoppel cannot give validity to the same. (Phil. Air Lines Employees Assoc. vs. Phil. Air Lines, Inc., 70 SCRA 244 [1976].)

(b) Similarly, where the separation from the service was illegal, the fact that the dismissed employees received their terminal pay cannot be considered as a waiver of their right to question the termination of their services. (Urgelio vs. Osmeña, 10 SCRA 253 [1964].)

(c) Employees who received their separation pay and other benefits are not barred from contesting the legality of their dismissal and the acceptance of said benefits would not amount to estoppel nor would it constitute waiver of the right to press for reinstatement. Quitclaims and/or complete releases executed by the employees do not estop them from pursuing their claims arising from illegal dismissal or the unfair labor practice of the employer if there is a showing of undue pressure or duress. (Garcia vs. National Labor Relations Commission, 153 SCRA 369 [1987]; San Miguel Corporation vs. Javate, Jr., 205 SCRA 459 [1992]; Solis vs. National Labor Relations Commission, 263 SCRA 629 [1996].)

Such quitclaims and/or complete releases being figuratively exacted through the barrel of a gun are against public policy and, therefore, null and void. Employer and employee, obviously do not stand on the same footing. Out of job and faced with the harsh necessities of life, the employee may find himself in no position to resist money proferred. (Zurbano, Jr. vs. National Labor Relations Commission, 228 SCRA 556 [1993]; Anino vs. National Labor Relations Commission, 290 SCRA 489 [1998]; JMM Promotions and Management, Inc. vs. Court of Appeals, 390 SCRA 223 [2002].)

But where it is shown that the person making the waiver did so voluntarily, with full understanding of what he was doing and the consideration for the quitclaim is credible and reasonable, the transaction must be recognized as a valid and binding undertaking.

(Alcosero vs. National Labor Relations Commission, 288 SCRA 129 [1998].)

(d) Also, the principles of estoppel and laches cannot be invoked against employees or laborers in an action for the recovery of compensation for past overtime work, as it would be contrary to the spirit of the law under which the laborers cannot waive their right to extra compensation. Moreover, an employee or laborer, who cannot expressly renounce the right to extra compensation, may be compelled to accomplish the same thing by mere silence or lapse of time, thereby frustrating the purpose of the law by indirection.

However, there may be cases in which the silence of the employee or laborer who lets the time go by for quite a long period without claiming or asserting his right to overtime compensation may favor the inference that he may not have worked any such overtime or that his extra work has been duly compensated. (Luzon Stevedoring Co., Inc. vs. Luzon Marine Dept. Union, 101 Phil. 257 [1957].)

(e) Estoppel cannot give validity to an act that is prohibited by law or one that is against public policy. The collection of interests without any express stipulation in writing is prohibited by law. (see Art. 1956) Consequently, the debtor cannot be considered to be estopped from denying the validity of the interests paid by him, which should be applied to the principal amount of his loan obligation. (Ching vs. Nicalao, 522 SCRA 316 [2007].)

(6) The principle of estoppel is *not applicable in probate proceedings relative to the question of testamentary capacity of a person.* Probate proceedings involve public interest, and the application therein of the rule of estoppel, when it will block the ascertainment of the truth as to the circumstances surrounding the execution of a testament, would be inimical to public policy. Over and above the interest of private parties is that of the State to see that testamentary dispositions be carried out if, and only if, executed conformably to law. (Alsua-Betts vs. Court of Appeals, 92 SCRA 332 [1979].)

(7) If a party having a right to pursue one of several inconsistent remedies (*e.g.*, specific performance and rescission) makes his election, institutes suit, and prosecutes it to final judgment, *such election of remedies constitutes an estoppel* thereafter, to pursue another and inconsis-

tent remedy. (Soriano vs. Sahagun, 10 SCRA 544 [1964].) Under Article 1367, when one of the parties has brought an action to enforce an instrument, he cannot subsequently ask for its reformation.

(8) The general rule is that estoppel does not apply to confer jurisdiction to a tribunal that has none over a cause of action. (Southeast Asian Fisheries Development Center vs. National Labor Relations Commission, 241 SCRA 580 [1995]; see De Leon vs. Court of Appeals, 245 SCRA 166 [1995]; Ebro III vs. National Labor Relations Commission, 261 SCRA 399 [1996].) Neither waiver nor estoppel shall apply to confer jurisdiction upon a court but the Supreme Court has ruled otherwise under highly meritorious and exceptional circumstances. (Asset Privatization Trust vs. Court of Appeals, 300 SCRA 579 [1998]; Heirs of C. Marasigan vs. Marasigan, 548 SCRA 409 [2008]; Figueroa vs. People, 558 SCRA 63 [2008].)

(a) A party is *estopped from disputing the jurisdiction of the court after invoking it himself.* After voluntarily submitting a cause and encountering an adverse decision on the merits, it is too late for the loser to question the jurisdiction[3] or power of the court. He cannot invoke the jurisdiction of a court to secure affirmative relief against his opponent and, after obtaining or failing to obtain

[3]As to cases on the operation of the principle of estoppel on the question of jurisdiction, see Tijam vs. Sibonghanoy, 23 SCRA 29 (1968); Pindangan Agricultural Co., Inc. vs. Dans, 6 SCRA 14 (1962); Montelibano vs. Bacolod-Murcia Milling Co., Inc., 6 SCRA 89 (1962); People vs. Casiano, 1 SCRA 478 (1961); Jimenez vs. Bucoy, 103 Phil. 40 (1958); San Agustin vs. Barrios, 68 Phil. 475 (1939); Toribio vs. Decasa, 55 Phil. 416 (1930); and People vs. Acierto, 92 Phil. 534 (1952).

The ruling in *Tijam* case that petitioner was estopped from questioning the jurisdiction of the land registration court in which it filed a petition for cancellation of title is a mere exception justified by the exceptional circumstances involved to the general rule that the issue of jurisdiction is not lost by waiver or estoppel. (Calimlim vs. Ramirez, 118 SCRA 399 [1982].) Estoppel does not apply to confer jurisdiction to a tribunal that has none over a cause of action. Jurisdiction is conferred by law. Where there is none, no agreement of the parties can provide one. (Southeast Asian Fisheries Dev. Center-Aquaculture Dept. vs. National Labor Relations Commission, 206 SCRA 283 [1992].)

If the lower court had no jurisdiction but the case was tried and decided upon the theory that it had jurisdiction, the parties are not barred, on appeal from assailing such jurisdiction, for the same must exist as a matter of law, and may not be conferred by consent of the parties or by estoppel. (Lozon vs. National Labor Relations Commission, 240 SCRA [1995].)

The ruling in *Tijam* that the defense of jurisdiction may be waived by estoppel on the part of the party invoking the same represented an exceptional case, rather than a general rule. (Metromedia Times Corporation vs. Pastoun, 465 SCRA 320 [2005]; Francel Realty Corporation vs. Sycip, 469 SCRA 424 [2005].) The general rule remains that a court's lack of jurisdiction may be raised at any stage of the proceedings even on appeal.

such relief, repudiate or question that same jurisdiction. (Marquez vs. Secretary of Labor, 171 SCRA 338 [1989]; Ocheda vs. Court of Appeals, 214 SCRA 629 [1992]; Sesbreño vs. Court of Appeals, 240 SCRA 606 [1995]; Province of Bulacan vs. Court of Appeals, 299 SCRA 442 [1998]; Duremdes vs. Duremdes, 415 SCRA 684 [2003]; Springsun Management Systems Corp. vs. Camerino, 449 SCRA 65 [2005]; Ponce vs. National Labor Relations Commission, 466 SCRA 348 [2005].)

A party will not be allowed to make a mockery of justice by taking inconsistent positions. Doctrine of estoppel bars a party from trifling with the courts. (Pio Barretto Realty Dev., Inc. vs. Court of Appeals, 131 SCRA 606 [1984]; TCL Sales Corporation vs. Court of Appeals, 349 SCRA 35 [2001].)

(b) While lack of jurisdiction may be assailed at any stage, a party's active participation in the proceedings before the court without jurisdiction may estop such party from assailing such lack of jurisdiction. Such active participation is tantamount to in insurrection of that jurisdiction and a willingness to abide by the resolution of the case. (Garcia vs. Court of Appeals, 202 SCRA 228 [1991]; People's Industrial & Commercial Corp. vs. Court of Appeals, 281 SCRA 206 [1997]; PNOC Shipping & Transport Corporation vs. Court of Appeals, 297 SCRA 402 [1998]; United Overseas Bank vs. Ros, 529 SCRA 334 [2007]; Prudential Guarantee & Assurance, Inc. vs. Equinox Land Corporation, 533 SCRA 257 [2007]; Estate of J.S. Yujuico vs. Republic, 537 SCRA 513 [2007]; Laya vs. Triviño, 551 SCRA 172 [2008].)

(c) The rule that the issue of jurisdiction over subject matter may be raised anytime, even during appeal, has been qualified where its application results in mockery of the tenets of fair play, as where the issue could have been disposed of earlier and more authoritatively by an administrative agency which is an expert in the matter at issue. (Benguet Corporation vs. Central Board of Assessment Appeals, 210 SCRA 579 [1992]; see Fortich vs. Corona, 298 SCRA 678 [1998].)

(d) A party, as already stated, will not be allowed to resort to the undesirable practice of submitting his case for decision and then accepting the judgment only if favorable, and attacking it for lack of jurisdiction. (Korean Airlines Co., Ltd. vs. Court of Appeals,

247 SCRA 599 [1995]; J. Lhuillier, Inc. vs. National Labor Relations Commission, 457 SCRA 784 [2005].) But in the absence of proof that the party raising the issue of lack of jurisdiction is barred by estoppel or laches, a decision rendered by a court without jurisdiction is a total nullity. (Dava vs. People, 202 SCRA 62 [1991]; see Pantranco North Express, Inc. vs. Court of Appeals, 224 SCRA 477 [1993].)

(9) It is in the social and public interest that crimes be punished. Hence, *criminal actions for public offenses cannot be waived or condoned,* much less barred by the rules of estoppel. (Talusan vs. Ofiana, 45 SCRA 467 [1972].)

(10) In labor jurisprudence, it is well-established that *quit claims and/or complete releases executed by employees do not estop them* from pursuing their claims arising from the unfair labor practice of the employer. The basic reason for this is that such quitclaims and/or complete releases are against public policy and, therefore, null and void. The acceptance of termination pay does not divest a laborer of the right to prosecute his employer for unfair labor practice acts. (AFP Mutual Benefit Assn., Inc. vs. AFP-MBAIEU, 97 SCRA 715 [1980]; see Mobile Protective & Detective Agency vs. Ompad, 458 SCRA 308 [2005].) There are, however, legitimate waivers that represent a voluntary and reasonable settlement of laborers' claims which should be respected as the law between the parties. "Dire necessity" is not an acceptable ground for annulling a release when it is not shown that the employee has been forced to execute it. (Magsalin vs. National Organization of Working Men, 403 SCRA 199 [2003]; Unicorn Safety Glass, Inc. vs. Basarte, 444 SCRA 287 [2004]; Mendoza, Jr. vs. San Miguel Foods, Inc., 458 SCRA 664 [2005].) While it is true that quit claims are frowned upon in labor claims, this holds true only when the consideration therefor is unconscionably low or there is clear proof that the waiver was wangled from an unsuspecting or gullible person. (National Federation of Labor vs. Court of Appeals, 440 SCRA 603 [2004]; Mindoro Lumber & Hardware vs. Bacay, 459 SCRA 714 [2005].) The burden of proving that quit claims were voluntarily entered into falls upon the employer. (Great Southern Maritime Services Corp. vs. Acuña, 452 SCRA 422 [2005]; see Universe Staffing Services, Inc. vs. National Labor Relations Commission, 559 SCRA 221 [2008]; Coats Manila Bay Inc. vs. Ortega, 579 SCRA 300 [2009].)

(11) Estoppel is *not favored in law because it excludes the truth.* (Coronel vs. Court of Industrial Relations, 24 SCRA 990 [1968].)

If anybody at all may be heard to challenge the application of the doctrine of estoppel, it is only the party against whom it may be invoked. (Castillo vs. Court of Appeals, 10 SCRA 549 [1964].)

**ART. 1433. Estoppel may be *in pais* or by deed.**

**Kinds of estoppel.**

The new Civil Code in Article 1433 gives only two (2) kinds of estoppel. Generally, estoppels are said to be of three kinds, namely:

(1) *Estoppel by record.* — It is the preclusion to deny the truth of matters set forth in a record, whether judicial or legislative, and also to deny the facts adjudicated by a court of competent jurisdiction. (28 Am. Jur. 2d. 600.) Well-settled is the rule that when a right or fact has been judicially tried and determined by a court of competent jurisdiction, as long as it remains unreversed, it should be conclusive upon the parties and those in privity with them applying the principle of *res judicata* or, otherwise, the rule on *conclusiveness of judgment*[4] (Church Assistance Program, Inc. vs. Sibulo, 171 SCRA 408 [1989].);

(2) *Estoppel by deed.* — It is a bar which precludes one party to a deed (*e.g.,* Art. 1434.) and his privies from asserting as against the other party and his privies any right or title in derogation of the deed, or from denying the truth of any material facts asserted in it. (28 Am. Jur. 2d. 602.) The rule promotes the judicious policy of making formal documents final and conclusive of their contents. A void deed, however, will not work, and may not be the basis of an estoppel. (Lopez vs. Court of Appeals, 398 SCRA 550 [2003].)

A distinction should be made between one who signs a document merely as an instrumental witness, and one who affixes his signature

[4]The less familiar concept or less terminological usage of *res judicata* as a rule on conclusiveness of judgment refers to the situation where the judgment in the prior action operates as an estoppel only as to matters actually determined therein or which were necessarily included therein. (Calalang vs. Register of Deeds, 208 SCRA 215 [1992], citing De la Cruz vs. Court of Appeals, 187 SCRA 165 [1990].) The doctrine of finality of judgment is grounded on fundamental considerations of public policy and sound practice and at the risk of occasional error, the judgment of courts must become final at some definite date fixed by law. (Alvendia vs. Intermediate Appellate Court, 181 SCRA 252 [1990]; Paramount Insurance Corporation vs. Japzon, 211 SCRA 879 [1992].)

as proof of his consent to, approval of, and conformity with the contents of the deed or document. The former simply attests that the party or parties to the instrument signed the same in his presence so that he is frequently referred to as a "witness to the signature" and he is not bound to know or be aware of the contents of the instrument, while the latter is not only presumed to know the subject matter of the deed but more importantly, binds himself thereto as effectively as the party himself would be bound thereby (Phil. National Bank vs. Court of Appeals, 98 SCRA 207 [1980].); and

(3) *Estoppel in pais (or by conduct).* — It is that which arises when one by his acts, representations, or admissions, or by his silence (*e.g.*, Art. 1437) when he ought to speak out, or by his acceptance of benefits derived from a certain act or transaction (*e.g.*, Art. 1438), intentionally or through culpable negligence, induces another to believe certain facts to exist and such other rightfully relies and acts on such belief as a consequence of which he would be prejudiced if the former is permitted to deny the existence of such facts. (see 31 C.J.S. 237.)

A party is estopped to challenge the personality of a corporation after having acknowledged the same by entering into a contract with it. (Georg Grotjahn GMBH & Co. vs. Isnani, 235 SCRA 216 [1994].) When the seller, instead of availing of his rights to rescind accepted and received delayed payments of installments beyond the period stipulated, and the buyer is in arrears, the seller, in effect, waive and is estopped from exercising said right to rescind. (Heirs of P. Escanlar vs. Court of Appeals, 281 SCRA 177 [1997].)

*Estoppel by laches* is that which arises from silence or inaction. *(infra.)* The rule is that an issue raised for the first time on appeal and not raised timely in the proceedings in the lower court is barred by estoppel. (Caltex [Phils.], Inc. vs. Court of Appeals, 212 SCRA 448 [1992].)

ILLUSTRATIVE CASE:

*Principal sought nullification of sale effected by agent seven (7) months after receiving checks in payment of price.*

*Facts:* P (principal) authorized A (agent) to look and negotiate for buyers of certain properties in order to get a better price than what may be obtained in an execution sale. The proceeds of the sale shall be applied to A's outstanding obligations to P.

Seven (7) months after receipt of the checks in payment of the purchase price, P returned the checks claiming that the price was "too low" and asserting that "it would be advantageous to both parties if the sale effected by A, was nullified and the property sold at public auction."

*Issue:* Is P guilty of estoppel?

*Held:* Yes. Having given A authorization to sell the properties, P should be held estopped from asserting an inconsistent position. The retention of the checks for seven (7) months without expressing any protest or objection was clear procrastination and indecision. *(Republic vs. Court of Appeals, 133 SCRA 505 [1984].)*

### Estoppel by record or by deed distinguished from estoppel *in pais.*

Estoppels by record and by deed are sometimes referred to as *technical estoppels* as distinguished from *equitable estoppels* or *estoppels in pais.*

Equitable estoppel is distinguished from technical estoppel in that it arises out of the acts or conduct of the party estopped and not from a record or deed. While technical estoppels are regulated by well-settled rules and admit of certain application, it would be difficult to prescribe a rule of universal application in regard to what are called estoppels *in pais*, depending as they do on the particular circumstances of the case. (28 Am. Jur. 2d. 600, 632.)

ILLUSTRATIVE CASE:

*Vendor invokes estoppel on the part of vendee to deny title of former to the property (land) sold, but latter's suit for reconveyance refers to other properties not included in the sale.*

*Facts:* B alleged in his suit for reconveyance that B fraudulently secured a certificate of title over an 8 hectare parcel of land, which parcel included that owned by B, "the same being on the *northeastern* part of the land covered by the certificate of title." S, in his answer, claimed that although he sold to B, subject to S's right to repurchase, only a portion of 4-1/4 hectares of the land covered by the title, B took possession of more than 7 hectares and thus deprived S of the possession of more than 3 hectares.

There are three pertinent statements of fact made in the deed of sale, to wit: (1) the parcel of land sold (4-1/4 hectares) was bounded on the

*north* by the property of S, the vendor; (2) said parcel is an integral part of the land described in the title issued in the name of S; and (3) since 1921 up to 1949 (when the deed was executed), S had been in continuous possession of the above described parcel of land.

*Issue:* May estoppel against B be predicated on the deed of sale *a retro* executed by both parties?

*Held:* No. None of the above three propositions are incompatible with the claim of B to the effect that he and his *causantes* owned the *northwestern* (not northern) portion of the land covered by the title of S. B's suit is precisely predicated upon the fact that this disputed portion was included in S's title. As to the claim of S that B admitted that S had been in possession as owner of the "above described parcel of land" since 1921, it is not definite whether said land refers to the 4-1/4 hectares sold or the entirety of the land included in the title of S. In truth, the probabilities are that it refers to the portion sold, for it is the boundaries of the same which are specified in the deed, while the limits of the entire area covered by the title are not specified.

Considering that to constitute an estoppel by deed, a distinct and precise assertion of fact is necessary, estoppel should be certain to every intent; and that estoppel by deed cannot prevent the denial of an equitable title which is not identical with the legal title, no estoppel can be predicated on the deed of sale *a retro* executed by both parties. The rule that a grantee is estopped to deny the title of his grantor is correct only if limited to the property actually conveyed and to the time of conveyance.

In this case, as the property subject of B's complaint was not the parcel bought by him under the deed, estoppel does not apply. *(Iriola vs. Felices, 30 SCRA 202 [1969].)*

### Rule of promissory estoppel.

(1) *Estoppel arising from a promise made without consideration.* — A party may not renege on his promises after the other had complied with the former's conditions, under the rule of promissory estoppel. The doctrine is by no means new, although the name has been adopted only in comparatively recent years.

According to this doctrine, an estoppel may arise from the making of a promise even though without consideration, if it was intended that the promise should be relied upon and, in fact, it was relied upon, and if a refusal to enforce it would be virtually to sanction the perpetration of fraud or would result in injustice to another. In this respect, the reliance of the promisee is generally by action or forbearance on his

part. (see 19 Am. Jur. 657-658, cited in Ramos vs. Central Bank of the Phil., 41 SCRA 565 [1971]; Republic Flour Mills, Inc. vs. Central Bank of the Phil., 93 SCRA 11 [1979]; Go Ong vs. Court of Appeals, 154 SCRA 270 [1970].)

Like the related principles of *volenti non fit injuria* (consent to injury), waiver, and acquiescense, the rule finds its origin generally in the equitable notion that one may not change his position and profit from his own wrongdoing when he has caused another to suffer a detriment by relying on his former promises or representations. (Gonzalo Sy Trading vs. Central Bank of the Phil., 70 SCRA 570 [1976].)

(2) *Elements.* — The doctrine of promissory estoppel is an exception to the general rule that a promise of future conduct does not constitute an estoppel. In some jurisdictions, in order to make out a claim of promissory estoppel, a party bears the burden to establish the following elements:

(a) promise reasonably expected to induce action or forbearance;

(b) such promise did in fact induce such action or forbearance; and

(c) the party suffered detriment as a result. (Mendoza vs. Court of Appeals, 359 SCRA 438 [2001], citing 28 Am. Jur. 2d 481.)

(3) *Nature or character of promise.* — The doctrine presupposes the existence of a promise on the part of one against whom estoppel is claimed. The promise must be plain and unambiguous. A cause of action for promissory estoppel does not lie where an alleged oral promise was conditional, so that reliance upon it was not reasonable. It does not operate to create liability where it does not otherwise exist. (*Ibid.*; Transfield Philippines, Inc. vs. Luzon Hydro Corp., 443 SCRA 307 [2004].)

In a case, the chattel mortgagor offered to the mortgagee (bank) real and personal properties as *dacion en pago.* Pursuant to this offer and by way of giving its implied consent, the mortgagee sent investigators and appraisers to evaluate the properties. There was no showing that the mortgagee assured the mortgagor that it was agreeable to the payment of the obligation by way of *dacion en pago,* held: "If the private respondent [bank] caused the appraisal of the properties offered, that could not be considered as a commitment on its part to enter into *dacion en pago.* At most it would only indicate that private

respondent wanted to study petitioner's [mortgagor's] proposal but found the properties unacceptable. Thus, the principle of promissory estoppel does not apply." (Komatsu Industries [Phils.], Inc. vs. Court of Appeals, 249 SCRA 361 [1995].)

ILLUSTRATIVE CASE:

*Central Bank liquidated a private bank after the latter complied with the conditions for its rehabilitation imposed by the former.*

*Facts:* OBM (a commercial banking corporation) had been suspended by the Central Bank (CB) from clearing with CB and from lending operations for various violations of banking laws and implementing regulations.

CB informed R, etc. (principal stockholders of OBM), that it would support and rehabilitate the OBM and avoid its liquidation if they would (a) execute a voting trust agreement turning over the management of OBM to CB or its nominees and (b) mortgage or assign their properties to CB to cover the overdraft balance of OBM. R, etc., complied with these conditions. Through the voting trust, CB caused its own team of nominees to take over the management and direction of OBM. Subsequently, CB Monetary Board adopted a resolution ordering the Superintendent of Banks to liquidate OBM.

*Issue:* Is the rule of promissory estoppel applicable?

*Held:* Yes. The Central Bank may not renege on its representations, and liquidate OBM, to the detriment of its stockholders, depositors, and other creditors. The conduct of the Central Bank reveals a calculated attempt to evade rehabilitating OBM despite its promises in violation of Articles 1159 and 1315 of the Civil Code. *(Ramos vs. Central Bank, supra.)*

### Requisites of estoppel *in pais.*

The essential elements of an equitable estoppel or estoppel *in pais* are:

(1) *As related to the party to be estopped. —*

(a) conduct which amounts to a false representation or concealment of material facts, or at least which is calculated to convey the impression that the facts are otherwise than, and inconsistent with those which the party subsequently attempts to assert;

(b) the intention or at least the expectation, that such conduct shall be acted upon, or influence, the other party or other persons; and

(c) knowledge, actual or constructive, of the real facts.

ILLUSTRATIVE CASES:

1. *Maker of a promissory note concealed from indorsee that it was issued for a gambling debt and assured him that the note was good.*

*Facts:* E (indorsee) acquired a promissory note for value from P (payee). The note was issued by M (maker) who assured E that the same was good. Without such assurance, E would not have bought the note in view of the fact that E inquired from M about the nature of the note before accepting its indorsement by P.

The note was issued for a gambling debt.

*Issue:* Is M relieved from the obligation of paying E the amount of the note?

*Held:* No. M is estopped from claiming that the note was given for a gambling debt. If such unlawful consideration did in fact exist, M deliberately and maliciously concealed it from E. *(Rodriguez vs. Martinez, 5 Phil. 67 [1905].)*

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2. *A person claimed to be estopped had no knowledge of the fact that his acceptance of a new appointment to the same position the name of which has been changed would deprive him of his right to claim the position when it is recreated and another is appointed thereto.*

*Facts:* PCSO alleged that by his acceptance of his appointment as, and his assumption of the duties of, General Field Supervisor, X is estopped from claiming the position of Assistant General Manager and impugning the appointment of Y to the said position. It appears that the position of Assistant General Manager was not abolished but its name was merely changed to General Field Supervisor.

Subsequently, the position of Assistant General Manager was recreated.

*Issue:* Is X in estoppel to claim the said position?

*Held:* No. Estoppel requires that a person claimed to be estopped must have knowledge of the fact that his voluntary acts would deprive him of some rights because said voluntary acts are inconsistent with said rights.

X assumed the duties of General Field Supervisor without, knowing, and neither was be made to understand, that thenceforth he should no longer claim the position of Assistant General Manager. His reaction to the appointment of Y to the recreated position was to claim the position

for himself. Had he allowed Y to continue in said position for some unreasonable length of time and while he, at the same time, continued performing the duties of GFS without any protest or objection, then it can be said that he would be deemed to have waived his right to the position of AGM, or estoppel to claim, the same. *(Board of Directors of Phil. Charity Sweepstakes Office vs. Alandy and Court of Appeals, 109 Phil. 1058 [1960].)*

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3. *Mortgagee-seller of a truck sold on installments, in giving the mortgagor-buyer the option to return the truck, did not know that the truck had been damaged because of an accident.*

*Facts:* B bought a truck on installments. To secure payment, he executed a chattel mortgage. When B defaulted on some installments. S, the mortgagee, demanded payment of the balance or the surrender of the truck. B replied he was voluntarily surrendering the truck, which was being repaired at a repair shop because it had met with an accident.

S decided not to get the truck. It filed an action to recover the unpaid balance of the promissory note.

*Issue:* Is S estopped to insist on its claim on the balance of the note when it demanded the return or surrender of the truck?

*Held:* No. To hold S in estoppel, it must be shown that when it gave B the choice of either paying the balance of the purchase price or of surrendering the truck, it had already knowledge of the accident and the consequent damage to the truck. In the present case, S claims it had no knowledge of the accident when it gave B the choice of either paying the balance of the promissory note or of surrendering the truck. It is hard to believe S would make such an offer to B either to pay the balance on the promissory note or to surrender the truck in question if it knew that the truck has had an accident. *(Industrial Finance Corp. vs. Tobias, 78 SCRA 28 [1977].)*

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4. *A party to a case, after securing a court order for the posting of a bond by the other party for the entry of a notice of lis pendens, asks for the cancellation of the notice.*

*Facts:* X filed a notice of *lis pendens.* Y secured from the court an order for the posting of a P5,000 bond by X to answer for damages resulting from the entry of *lis pendens* notice.

Y now asks for the cancellation of the notice.

*Issue:* Is Y in estoppel to ask for the cancellation of the notice?

*Held:* Yes. Having elected to allow the notice to remain, provided, the bond is filed, Y cannot turn around to demand that the notice be cancelled. He impliedly admitted that the notice was a proper one. *(Garchitorena vs. Register of Deeds of Camarines Sur, [Unrep.] 101 Phil. 1207 [1957].)*

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5. *A department head of the Social Security System (SSS) made an erroneous representation that borrower's MRI coverage included permanent total disability.*

*Facts:* Spouses TN and JN were granted in 1967 a housing loan by the SSS secured by a mortgage on their lot and a MRI (mortgage redemption insurance) policy procured by the SSS on the life of its principal debtor, TN, the husband, who was an SSS member. Under the provisions of the policy, SSS will apply to the indebtedness of the mortgagor the full proceeds thereof in case of death of the mortgagor. TN was declared permanently disabled in 1970. As early as 1967, JN inquired about the coverage of the MRI policy from the head of the SSS Real Estate Department (RED) who replied that it covered death as well as permanent disability.

SSS denied the request of JN to have the MRI applied to the loan due to the permanent total disability of TN, claiming that the only contingency covered by the policy was death and that the representation made by the head of the Real Estate Department was an honest mistake and could not bind the SSS.

*Issue:* May SSS be compelled to discharge the balance of the mortgage loan obligation on the ground of estoppel?

*Held:* No. The SSS was not estopped to claim that the MRI covered the risk of death alone. It appeared that what was disclosed by the head of the RED was a mere plan which he mistakenly believed would be approved by the SSS which, however, did not materialize. Estoppel being a principle of equity, it would not be equitable to allow JN to profit by such mistake.

Furthermore, JN did not actually rely on such representation. For while TN was declared disabled on January 1, 1970, it was not until July 1, 1974 when JN asked that the MRI be applied to the loan due to the disability of her husband. This delayed action was not compatible with the claim that they had relied on the representation. *(Noda vs. Social Security System, 109 SCRA 218 [1981].)*

(2) *As related to the party claiming the estoppel. —*

(a) ignorance or lack of knowledge and of the means of knowledge of the truth as to the facts in question;

(b) reliance in good faith, upon the conduct or statement of the party to be estopped; and

(c) action or inaction based thereon of such a character as to change the position or status of the party claiming the estoppel, to his injury, detriment, or prejudice. (28 Am. Jur. 2d. 640-641; see Vega vs. San Carlos Milling Co., 51 Phil. 921 [1928]; Kalalo vs. Luz, 34 SCRA 337 [1970]; Cruz vs. Court of Appeals, 201 SCRA 495 [1991].)

In technical estoppel, the party to be estopped must knowingly have acted so as to mislead his adversary and the adversary must have placed reliance on the action and acted as he would otherwise not have done. Some authorities, however, held, that what is tantamount to estoppel, may arise without this reliance on the part of the adversary and this is called ratification or election by acceptance of benefits, which arises when a party, knowing that he is not bound by a defective proceeding and is free to repudiate it if he will, upon knowledge, and while under no disability, chooses to adopt such defective proceeding as his own. (Maglucot-Aw vs. Maglucot, 329 SCRA 782 [2000]; Cortes vs. Court of Appeals, 395 SCRA 33 [2002].)

ILLUSTRATIVE CASES:

1. *A party, after accepting a new offer which omitted any reference to salary previously claimed by him and on the basis of which the other entered into a contract, asserts again his claim for said salary.*

*Facts:* In the course of the negotiations for the sale to B of S's interest in the stock of a corporation, S asked payment of salary alleged to be due to him for services rendered to the corporation. Upon being informed that B would not proceed with the negotiations unless S withdraws his claim for salary, S drew up another offer which omitted all reference to the salary.

B and S subsequently entered into a contract on the basis of the offer, settling all existing differences except as to the salary.

*Issue:* Is S in estoppel to assert the claim for salary?

*Held:* Yes. Having led B to believe that the claim for salary had been waived and to contract on that basis, S is estopped from asserting the claim. *(Herman vs. Radio Corp. of the Phil., 50 Phil. 490 [1927].)*

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2. *An owner of property, to defeat the claims of his creditors, made it appear by a notarial act that another was the owner and estoppel is invoked by the latter or his successors against the real owner.*

*Facts:* S, the owner of a piece of property, executed a notarial act tending to show falsely that his brother B, was the owner of the property mentioned in the document. The real title at the time the declaration was made was in S.

In creating this document, S, in collusion with B, was merely laying the basis of a scheme to defeat the creditors of S.

*Issue:* Are S and his successors estopped from claiming said lot?

*Held:* If this admission had ever been acted upon by any third person purchasing from B, S would have been estopped from asserting ownership in himself. But no estoppel can be invoked by B or his successors, based upon this document for the reason that he was not misled by the false statement contained therein. An equitable estoppel can only be invoked by one who is in a position to be misled by the misrepresentation with respect to which the estoppel is invoked, and under circumstances where damage would result to him from the adoption by the person estopped of a position different from that which has been held out to be true. *(Cristobal vs. Gomez, 50 Phil. 810 [1927].)*

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3. *Personal property delivered for sale is pledged instead by the agent and estoppel is invoked by the pledgee against the principal (owner).*

*Facts:* P (principal) delivered his diamond ring to A (agent) solely for sale on commission, but the latter instead pledged the same without authority to do so with X's pawnshop.

*Issue:* Is P estopped from pursuing an action against the pawnshop for the recovery of the said ring?

*Held:* No. For estoppel to exist, it is indispensable that there be, a declaration, act, or omission by the party who is sought to be bound. It is equally a requisite that he, who would claim the benefits of such a principle, must have altered his position, having been so intentionally and deliberately led to comfort himself thus, by what was declared or what was done or failed to be done.

In this case, there is absence of an act or omission by P, as a result of which a position had been assumed by X. Neither the promptings of equity nor the mandates of moral right and natural justice come to X's rescue. X is engaged in a business authorized to impose a higher rate of interest precisely due to the greater risk assumed by him. He ought to

have been on his guard before accepting the pledge in question. If no such care be taken, perhaps because of the difficulty of resisting opportunity for profit, he should be the last to complain if thereafter the right owner of such jewelry should be recognized. The law for this sound reason accords the latter protection.[5] *(Dizon vs. Suntay, 47 SCRA 160 [1972].)*

**Diligence of party claiming equitable estoppel.**

One who claims the benefit of an estoppel on the ground that he has been misled by the representation of another must not have been misled by his own want of reasonable care. Good faith is generally regarded as requiring the exercise of reasonable diligence to learn the truth. (28 Am. Jur. 2d. 721-722.) Estoppel is a shield against injustice and a party invoking its protection should not be allowed to use the same to conceal his or her own negligence. (Mijares vs. Court of Appeals, 271 SCRA 558 [1997].)

Accordingly, the doctrine of estoppel does not extend in favor of those who are charged with notice of the true facts, or of facts and circumstances which through due diligence, could have disclosed those true facts in connection with which the representation was made, and if he fails to do so or intentionally closes his eyes to the ascertainment of the ultimate truth, he cannot later on be heard to say that he was led to believe what has been represented to him. (Mercado vs. Abatajo, [CA] No. 16323-R, Feb. 18, 1957.)

**Equitable estoppel distinguished from waiver.**

Waiver and estoppel are often loosely used interchangeably. The doctrine of waiver, it has been said, belongs to the family of, or is based upon, estoppel. The essence of waiver, it has been stated, is estoppel and where there is no estoppel, there is no waiver. (Lopez vs. Ochoa, 103 Phil. 950 [1958].)

Nevertheless, there are well-recognized distinctions between the two, and the one may exist without or apart from the other.

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[5]Article 559 applies. It provides: "The possession of movable property acquired in good faith is equivalent to a title. Nevertheless, one who has lost any movable or has been unlawfully deprived thereof, may recover it from the person in possession of the same.

If the possessor of a movable lost or of which the owner has been unlawfully deprived, has acquired it in good faith at a public sale, the owner cannot obtain its return without reimbursing the price paid therefor." (464a)

(1) A waiver is a voluntary and intentional abandonment or relinquishment of a known right, whereas an equitable estoppel may arise even though there was no intention on the part of the party estopped to relinquish or change any existing right;

(2) Waiver does not necessarily imply that the party asserting it has been misled to his prejudice, whereas prejudice to the other party is one of the essential elements of an equitable estoppel;

(3) Waiver involves the conduct of only one of the parties, that is, it depends upon what one himself intended to do regardless of the attitude assumed by the other party, but equitable estoppel involves the conduct of both parties, since it is based upon some misleading conduct or language of one person and reliance thereon by another who is misled thereby to his prejudice; and

(4) Estoppel frequently carries the implication of fraud, but waiver never does. (28 Am. Jur. 2d. 634-635.)

**When estoppel and waiver used as interchangeable.**

Where waiver implied from conduct is involved, the dividing line is somewhat less distinct. In the law of insurance, for instance, the two terms have come to be quite commonly used interchangeably. *(Ibid.)*

Thus, an insurer which, with knowledge of facts entitling it to treat a policy as no longer in force, receives and accepts a premium on the policy is estopped to take advantage of the forfeiture. It cannot treat the policy as void for the purpose of defense to an action to recover for a loss thereafter occurring and at the same time treat it as valid for the purpose of earning and collecting further premiums. (see Qua Chee Gan vs. Law Union & Rocks Ins. Co., 98 Phil. 85 [1955].) Having thus accepted and enjoyed the benefits resulting from the collection of the premiums (see Art. 1438.), it is estopped from questioning the validity of the policy or is deemed to have waived the right to contest.

**Equitable estoppel distinguished from ratification.**

Estoppel differs in essential particulars from ratification, as follows:

(1) The substance of ratification is confirmation after conduct, while that of estoppel is the inducement to another to act to his prejudice;

(2) In ratification, a party is bound because he intended to be, while in estoppel, he is bound notwithstanding that there was no such intention because the other party will be prejudiced and defrauded by his conduct unless the law treats him as legally bound; and

(3) Ratification does not rest upon prejudice, while estoppel is applied if the other party would be unjustly prejudiced. (28 Am. Jur. 2d. 635-636.)

**Estoppel arising from silence or inaction.**

Estoppel may arise under certain circumstances from silence or inaction as well as from words or actions. Estoppel by silence or inaction or *estoppel by laches* is often referred to as estoppel by "standing by." The principle underlying this type of estoppel is embodied in the maxim that "if one maintains silence when in conscience he ought to speak, equity will debar him from speaking when in conscience he ought to remain silent. He who remains silent when he ought to speak cannot be heard to speak when he should be silent." (People vs. Escote, Jr., 400 SCRA 603 [2003].)

But mere innocent silence or inaction will not work an estoppel. Thus, mere silence on the part of a man's legal wife with knowledge of his pretended second marriage does not estop her from asserting her right to inherit from him where she neither encouraged nor asserted to the illegitimate marriage. (Williams vs. Lee, 28 ALR 1124.) There must be some element of turpitude or negligence connected with silence or inaction by which the other party is misled to his injury.

In other words, to give rise to estoppel by silence or inaction, there must be a right and an opportunity to speak and in addition, an obligation or duty to do so. (28 Am. Jur. 2d. 665-668; see Lopez vs. Abelarde, 36 Phil. 563 [1917]; Esso Standard Eastern, Inc. vs. Manila Railroad Co., 93 SCRA 309 [1979].) Silence without knowledge of the facts works no estoppel. (Bernardo vs. Court of Appeals, 7 SCRA 367 [1963]; Beronilla vs. GSIS, 36 SCRA 44 [1970]; Lodovica vs. Court of Appeals, 65 SCRA 154 [1975]; Phil. Air Lines Employees' Asso. vs. Phil. Air Lines, Inc., 70 SCRA 244 [1976].)

The defense of laches must be invoked in the answer, otherwise it is waived. (Budlong vs. Pondoc, 79 SCRA 24 [1977]; see Sec. 2, Rule 9, Rules of Court.)

**Meaning of laches.**

In a general sense, *laches* is failure or neglect, for an unreasonable and unexplained length of time, to do that which, by exercising due diligence, one could or should have done earlier; it is negligence or omission to assert a right within a reasonable time, warranting a presumption that the party entitled to assert it either has abandoned it or declined to assert it. (Tijam vs. Sibonghanoy, 23 SCRA 29 [1968]; Castañeda vs. Ago, 65 SCRA 505 [1975]; People vs. Consulta, 70 SCRA 277 [1976]; Republic vs. Heirs of Felix Caballero, 79 SCRA 177 [1977].)

Laches, thus amounts to an implied waiver arising from knowledge of existing conditions and an acquiescence in them (Gutierrez vs. Bachrach Motor Co., 105 Phil. 29 [1959]; Rivera vs. Court of Appeals, 244 SCRA 218 [1995].) for an unreasonable length of time — "for time is a means of dissipating obligations and actions, because time runs against the slothful and careless of their own rights." (Leonardo vs. Maravilla, 393 SCRA 156 [2002].)

**Essence, basis, and elements of estoppel by laches.**

(1) *Essence.* — The essence of laches is the doctrine of estoppel, a concept derived from American law that aims to bring out justice between parties, through the operation of the principle that an admission or representation is rendered conclusive upon the person making it and cannot be denied or disproved as against the person relying thereon. (Mejia vs. Patcho, 132 SCRA 540 [1984], citing the Report of the Code Commission, p. 59.)

(a) Laches is not concerned with mere lapse of time. *(infra.)* The mere fact of delay is insufficient to constitute laches. It is essential that there be also acquiescence in the alleged wrong or lack of diligence in seeking a remedy. (Southern Pacific N. Bogert, 250 US 483, cited in Cristobal vs. Melchor, 78 SCRA 175 [1977].) It is required that: 1) complainant must have knowledge of the conduct of the defendant or one under whom he claims; and 2) he must have been afforded an opportunity to institute suit. (Gabriel vs. Court of Appeals, 159 SCRA 46 [1988]; Donato vs. Court of Appeals, 217 SCRA 196 [1993].)

"The law serves those who are vigilant and diligent and not those who sleep when the law requires them to act" (Bacolod-Murcia Milling Co., Inc. vs. Villaluz, 90 Phil. 154 [1951]; Vda. de

Alberto vs. Court of Appeals, 173 SCRA 436 [1989].), either by their negligence, folly or inattention (Caltex [Phils.], Inc. vs. Court of Appeals, 292 SCRA 273 [1998].), or by their silence, delay and inaction. (Clavereas vs. Quingco, 464 SCRA 207 [2005]; Equity as an exceptional extenuating circumstances does not favor, nor may it be used to reward, the indolent or the wrongdoer. A party should not, in the guise of equity, be allowed to benefit from its own fault. (Tirazona vs. Philippine EDS Techno-Service, Inc., 576 SCRA 625 [2009].)

(b) Laches presupposes waiver of one's rights. (Umibay vs. Alecha, 135 SCRA 427 [1985].) The doctrine presumes that the party guilty of negligence had the opportunity to do what should have been done, but failed to do so. Conversely, if the said party did not have the occasion to assert the right, then, he cannot be adjudged guilty of laches. (Juco vs. Heirs of T. Siy Chung Fu, 451 SCRA 464 [2005]; O vs. Javier, 591 SCRA 656 [2009].) No laches attaches where, for example, the owner of a land immediately filed suit upon discovery that the same was covered by a transfer certificate of title in the name of another person (St. Peter Memorial Park, Inc. vs. Cleofas, 92 SCRA 389 [1979].); or where a party became aware of the encroachment on his property only after he hired a surveyor to ascertain the true area and boundaries of his lot (Umibay vs. Alecha, *supra*.); or where a co-owner had no knowledge of the sale by the co-owner of the land in question and opportunity to institute the proper action. (Bailon-Casilao vs. Court of Appeals, 160 SCRA 738 [1988].)

(c) The doctrine of laches and estoppel cannot be successfully invoked absent any element of turpitude or negligence connected with the silence by which another is misled to his injury. (Tac-an Dano vs. Court of Appeals, 137 SCRA 803 [1985].)

(d) Neither will laches attach to contracts that are null and void. (Art. 1410; see Phil. National Bank vs. Court of Appeals, 98 SCRA 207 [1980].)

(e) In labor cases, laches may be applied only upon the most convincing evidence of deliberate inaction, for the rights of laborers are protected under the social justice provision of the Constitution and the Civil Code. (Reno Foods, Inc. vs. National Labor Relations Commission, 249 SCRA 879 [1995]; Hagonoy

Rural Bank vs. National Labor Relations Commission, 285 SCRA 297 [1998].)

(f) The principle of laches does not attach when the judgment is null and void for want of jurisdiction which the party against whom the principle is invoked had always consistently questioned and assailed. Estoppel, being an equitable doctrine, cannot be invoked to perpetuate an injustice. (Pio Barreto Dev. Corp. vs. Court of Appeals, 360 SCRA 127 [2001].)

(g) Although a registered landowner may lose his right to recover possession of his property by reason of laches, the equitable defense is unavailing to one who has not shown any color of title to the property. An intruder or squatter has no possessory rights over the land intruded upon. His occupancy being merely tolerated, it cannot affect the possession of the owner to whom he is bound to an implied promise to vacate upon demand. (D'Oro Land Realty & Dev. Corp. vs. Claunan, 516 SCRA 681 [2007].)

(h) The existence of confidential relationship between the parties is an important circumstance for consideration; a delay under such circumstance not being so strictly regarded. Similarly, the fact that parties are connected by ties of blood or marriage tends to excuse an otherwise unreasonable delay. (Abadiano vs. Martir, 560 SCRA 676 [2008].)

(2) *Basis*. — The doctrine of laches or of "stale demands" is based upon grounds of public policy which requires, for the peace of society, the discouragement of stale claims. Unlike the statute of limitations, laches is not a mere question of time but is principally a question of the inequity or unfairness of permitting a right or claim to be enforced or asserted. (*Ibid.;* see Crisostomo vs. Court of Appeals, 32 SCRA 54 [1970]; Z.E. Lotho, Inc. vs. Ice and Cold Storage Industries of the Phil., 3 SCRA 744 [1961]; Bergado vs. Court of Appeals, 173 SCRA 497 [1989]; Placewell International Services Corp. vs. Camote, 492 SCRA 761 [2006].)

Since laches is a creation of equity, acts or conduct alleged to constitute the same must be intentional and unequivocal so as to avoid injustice.

It operates not really to penalize neglect or failure to assert a right within a reasonable time but rather to avoid recognizing a right when to do so would result in a clearly inequitable situation or in an

injustice. (Associated Bank vs. Court of Appeals, 291 SCRA 571 [1998]; Maestrado vs. Court of Appeals, 327 SCRA 678 [2000]; Republic vs. Court of Appeals, 454 SCRA 516 [2005].)

As an equitable defense, laches does not concern itself with the character of the defendant's title, but only with whether or not by reason of plaintiff's long inaction or inexcusable neglect he should be barred in equity from asserting his claim at all. (Catholic Bishop of Balanga vs. Court of Appeals, 263 SCRA 181 [1996]; Far East Bank and Trust Co. vs. Querimit, 373 SCRA 665 [2002]; Velez, Sr. vs. Demetrio, 387 SCRA 232 [2002].)

But it cannot be invoked to defeat justice or to perpetuate fraud or injustice. (Donato vs. Court of Appeals, *supra;* Jimenez vs. Fernandez, 184 SCRA 190 [1990].) Thus, it would be patently unjust to apply laches against the alleged seller and vest ownership over a valuable piece of real property in favor of the alleged buyer by virtue of an absolutely simulated deed of sale never meant to convey any right over the subject property. (Santiago vs. Court of Appeals, 278 SCRA 98 [1997].)

There is no absolute rule as to what constitutes laches or staleness of demand. The question of laches is addressed to the sound discretion of the court, to be determined according to the particular circumstances of each case. It is evidentiary in nature which cannot be established by mere allegations in the pleadings and cannot be resolved in a motion to dismiss (Felix Gochan & Sons Realty Corp. vs. Heirs of Baba, 409 SCRA 306 [2003]; Dept. of Education vs. Oñate, 524 SCRA 200 [2007].) Since laches is an equitable doctrine, its application is controlled by equitable considerations. Courts will not be guided or bound strictly by the statute of limitations or the doctrine of laches when to do so, manifest wrong or injustice would result. (Sotto vs. Teves, 86 SCRA 154 [1978]; Velez, Sr. vs. Demetrio, 387 SCRA 232 [2002]; Romero vs. Natividad, 461 SCRA 553 [2005]; Heirs of R. Dumaliang vs. Serban, 516 SCRA 343 [2007]; United Overseas Bank vs. Ros, 529 SCRA 334 [2007].)

In other words, where a court of equity finds that the position of the parties has to change but equitable relief cannot be afforded without doing injustice, or that the intervening rights of third persons[6]

[6]There is a host of jurisprudence that hold that prescription and laches could not apply to registered land covered by the torrens system. With more reason with respect to laches which is an equitable principle. Laches may not prevail against a specific provision of law,

may be destroyed or seriously impaired, it will not exert its equitable powers in order to save one from the consequences of his own neglect. In effect, the principle is one of estoppel because it prevents one who has slept on his rights from prejudicing the rights of another who has placed reliance on his inaction. (Mejia de Lucas vs. Gamponia, 100 Phil. 277 [1950]; Heirs of J. and I. Panganiban vs. Dayrit, 464 SCRA 370 [2005].) But unlike estoppel, laches, as an equitable defense usually bars only the equitable enforcement of a right but not the right itself. It is an affirmative defense and the burden of proving it rests on the defendant. (Phil. Bank of Communications vs. Court of Appeals, 289 SCRA 178 [1998].) Equitable rights barred by laches still subsist albeit in an empty manner as the guilty party cannot assert them judicially, but they may be revived or activated by the waiver of those whose rights have ripened due to the laches, and can be exercised to the extent of the rights waived. (Heirs of C. Reyes vs. Calumpang, 506 SCRA 56 [2006].)

(3) *Elements.* — The equitable doctrine of estoppel by laches requires four elements:

(a) conduct on the part of the defendant, or of one under whom he claims, giving rise to the situation of which complaint is made;

(b) delay in asserting the complainant's right, the complainant having had knowledge or notice of the defendant's conduct and having been afforded an opportunity to sue; actual knowledge of the commission of the adverse act is not necessary, it being enough that such knowledge may be imputed to the complainant because of circumstances of which he was cognizant;

(c) lack of knowledge or notice on the part of the defendant that the complainant would assert the right on which he bases his suit; and

(d) injury or prejudice to the defendant in the event relief is accorded to the complainant, or the suit is not held to be barred. (Miguel vs. Catalino, 26 SCRA 234 [1968]; Custodio vs. Casiano, 9 SCRA 841 [1963]; Yusingco vs. Ong Hing Lian, 42 SCRA 589

since equity, which has been defined as "justice outside legality," is applied in the absence of and not against statutory law or rules of procedure. (see Mateo vs. Diaz, 374 SCRA 33 [2002].) See, however, Note 7.

[1971]; Maglira vs. Court of Appeals, 96 SCRA 650 [1980]; Chacon Enterprises vs. Court of Appeals, 124 SCRA 784 [1983]; Cimafrancia vs. Intermediate Appellate Court, 147 SCRA 611 [1987].)

The second element is three-tiered. There must be 1) knowledge of defendant's action; 2) opportunity to sue defendant after obtaining such knowledge; and 3) delay in the filing of such suit. (Vda. de Tirona vs. Encarnacion, 534 SCRA 394 [2007].) The last element is the origin of the doctrine that stale demands apply only where by reason of the lapse of time it would be inequitable to allow a party to enforce his legal rights. (Jison vs. Court of Appeals, 286 SCRA 495 [1998].)

Laches extends to one's heirs since they stand in privity with him. (Heirs of Batiog Lacamen vs. Heirs of Laruan, 65 SCRA 605 [1975]; see Art. 1439.)

ILLUSTRATIVE CASES:

1. *Vendor and his heirs did not take any step for more than 34 years to recover from the vendee, land sold without executive approval as required by law.*

*Facts:* S, a non-Christian, sold in 1928 a parcel of land to B without executive approval as required by law. Notwithstanding the invalidity of the sale, S allowed B to possess and enjoy the land without protest from 1928 to 1948, when S died.

C, the son, who succeeded S, did not take any step to recover the property from 1948 to 1962, when suit was finally instituted in court.

*Issue:* Is the suit barred by laches?

*Held:* Yes. Even granting no prescription lies against S's recorded title, the passivity and inaction of S and C for more than 34 years justifies B in setting up the equitable defense of laches. *(Miguel vs. Catalino, 26 SCRA 234 [1968].)*

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2. *Heirs of grantee of homestead sought the recovery after more than 30 years of the land sold by said grantee.*

*Facts:* S, a grantee of a homestead, for which he was issued an original certificate of title, sold in a private document the said land to B who, in a public instrument, sold the property to C, who in turn, sold the same land to D who immediately took possession thereof and paid taxes therefor in the name of S as the title and assessment of the land remained in S. The land was sold at public auction for non-payment of the taxes and was bought by P (province).

The heirs of S brought action against D for the recovery of the property, alleging, among other things, that D occupied the homestead as lessee under a verbal agreement with S, and that the lease agreement had expired. The action was dismissed for lack of interest. Another action by the heirs on the ground that the sale from C to D was null and void was also dismissed on the ground of *res judicata.*

E, one of the heirs of S, acquired the interest of the others in the property. The provincial treasurer allowed the repurchase of the land by E after refusing the redemption by D. E contends that when P acquired the property at the tax auction sale, a certificate of title was issued to P "free from all liens and encumbrances," that when he purchased the property and a transfer certificate of title was issued to him, he was a purchaser in good faith for value, and that it is the act of registration that operates to convey or affect this registered property.

*Issue:* Who is entitled to the ownership and possession of the property, D or E?

*Held:* D. When E repurchased the property, the action of E and his co-heirs was dismissed on the ground of *res judicata*. D and his predecessors-in-interest have been in continuous possession of the parcel for 30 years under claim of ownership without the heirs or their predecessors questioning the former's adverse possession. As a result of their inaction the property was sold by B to C who, in turn, sold it to D.

While it cannot be denied that no title to registered land in derogation to that of the registered owner shall be acquired by prescription or adverse possession, this legal guarantee may in appropriate cases yield to the right of a third person on the equitable principle of laches. *(Mapa III vs. Guanzon, 77 SCRA 387 [1977].)*

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3. *A dismissed employee who was promised reinstatement by the defendant from time to time, filed a complaint for reinstatement beyond the period prescribed by the Rules of Court.*

*Facts:* X and five (5) other employees in the President's Private Office, Malacañang, Manila, were dismissed from the service. Their requests for reconsideration were denied by the President. The five (5) employees, not including X, filed a complaint in court for reinstatement. Their complaint was dismissed by the lower court but the Supreme Court declared their dismissal illegal and ordered their reinstatement. During the pendency of the case, X continued to press for reinstatement and was in fact promised reinstatement by the Executive Secretary as well as by the successor of the latter.

After the decision of the Supreme Court, X requested reinstatement which was denied repeatedly. X's complaint for reinstatement was dismissed by the trial court for having been filed beyond one (1) year after cause of ouster, citing Section 16, Rule 66 of the Rules of the Court.

*Issue:* Is the principle of laches applicable against X?

*Held:* No. There was no acquiescence to or inaction on the part of X amounting to abandonment of his right to reinstatement. He could be expected — without necessarily spending time and money by going to court — to rely upon the outcome of the case filed by his co-employees to protect his interest considering the similarity of his situation to that of them and the identical relief sought. It is not essential that X should intervene in the suit brought by his co-employees in order that he be deemed thereafter free from laches which bars those who sleep on their right.

The doctrine of laches is an equitable principle applied to promote but never to defeat justice. Thus, where laches is invoked against a plaintiff by reason of the latter's failure to come to court within the statutory period provided by law, the doctrine of laches will not be taken against him when the defendant is shown to have promised from time to time to grant the relief sought. *(Cristobal vs. Melchor, 78 SCRA 175 [1977].)*

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4. *The long inaction of the vendor's heirs to recover the land sold was due to their being minors.*

*Facts:* S, patentee of a piece of public land, sold the same to B, in violation of the homestead law. C, D, and E, children and heirs of S, were still minors at the time of the void sale in 1932 and when they executed in 1946 a document recognizing the sale made by their father who died in 1935, C was still a minor and could not sign the document.

Within two and half years later, after attaining the age of majority, they promptly repudiated the document and filed suit for recovery of the land.

*Issue:* May laches be successfully asserted against the plaintiffs?

*Held:* No. The defense of laches is an equitable one concerned only with whether or not by reason of the plaintiff's long inaction or inexcusable neglect, he should be barred from asserting his claim at all, because to allow him to do so would be inequitable and unjust to defendant. The facts show no such long inaction or inexcusable neglect on plaintiffs' part. Furthermore, the public policy on which our homestead law is predicated requires that the plaintiffs be not prevented from reacquiring

the land because it was given to them by law for home and cultivation. This right cannot be waived. *(Gayotin vs. Tolentino, 79 SCRA 578 [1977].)*

**Laches distinguished from prescription.**

Laches is different from, and applies independently of, prescription.

(1) Laches is not concerned merely with lapse of time unlike prescription. While the latter is concerned with the fact of delay, laches deals with the effect of unreasonable delay, *i.e.,* the guilty party had an opportunity to assert his claim but failed to do so;

(2) Laches is principally a question of the inequity or unfairness of permitting a stale right or claim to be enforced or asserted, this inequity being founded on some change in the condition or the relation of the parties, while prescription is a question or matter of time;

(3) Laches is not statutory, while prescription is statutory;

(4) Laches applies in equity, while prescription applies at law; and

(5) Laches is not based on a fixed time, while prescription is based on a fixed time. (Miguel vs. Catalino, *supra;* Nielson and Co., Inc. vs. Lepanto Consolidated Mining Co., 18 SCRA 1040 [1966]; Heirs of Batiog Lacamen vs. Heirs of Laruan, 65 SCRA 605 [1975]; Mapa III vs. Guanzon, 77 SCRA 387 [1977]; Vda. de Cabrera vs. Court of Appeals, 267 SCRA 339 [1997]; Pilapil vs. Heirs of M.R. Briones, 514 SCRA 197 [2007].)

Unlike the statute of limitations, laches does not involve mere lapse or passage of time but is principally an impediment to the assertion or enforcement of a right which has become under the circumstances inequitable or unfair to permit. (Phil. Bank of Communications vs. Court of Appeals, 289 SCRA 178 [1998]; Chung Ka Bio vs. Intermediate Appellate Court, 163 SCRA 534 [1988].) Thus, while it is true that a torrens title is indefensible and imprescriptible, the registered landowners may lose his right to recover the possession of his registered property by reason of laches. (De Vera-Cruz vs. Miguel, 468 SCRA 506 [2005].)

**Laches not based on a fixed time.**

Laches can be invoked without reckoning any specific or fixed period. It is sufficient that there be unreasonable and unexplained delay in bringing the action that its maintenance would already

constitute inequity or injustice to the party invoking. (San Miguel Corp. vs. Cruz, 31 SCRA 819 [1970].) Hence, while it is true that technically, the action to have a contract declared *void ab initio* does not prescribe, it may nonetheless be barred by laches. (Kafols vs. Barba, 119 SCRA 146 [1982].) Thus, the doctrine of laches may find application even to imprescriptible actions, such as an action to annul a void or in-existent contract. (see Buenaventura vs. Court of Appeals, 216 SCRA 818 [1992].) While registered land may not be acquired by prescription, title to it may be acquired by virtue of the equitable principle of laches.[7] (Lola vs. Court of Appeals, 145 SCRA 439 [1986].)

Equity has been aptly described as "justice outside legality." It is applied only in the absence of, and never against, statutory law or judicial rules of procedure. (Zabat, Jr. vs. Court of Appeals, 142 SCRA 587 [1986].) Thus, the doctrine of laches was held inapplicable where the claim was filed within the prescriptive period provided by law. (Chavez vs. Bonto-Perez, 242 SCRA 73 [1995]; Associated Bank vs. Court of Appeals, 291 SCRA 511 [1998]; Maestrado vs. Court of Appeals, 327 SCRA 678 [2000]; D.B.T. Mar-Bay Construction, Inc. vs. Panes, 594 SCRA 578 [2009].)

In a case, the lapse of nine (9) years within which the respondent had not instituted her suit for collection of a sum of money which had a prescriptive period of 10 years, was not considered as unreasonable delay to warrant the application of laches. The doctrine of laches, being an equitable principle, should not be applied to supplant what is clearly stated in the law especially if it would defeat and not promote justice. (Biala vs. Court of Appeals, 191 SCRA 50 [1990].)

The doctrine of laches should not be applied earlier than the expiration of time limited for the commencement of actions at law, unless, as a general rule, inexcusable delay in asserting a right and acquiescense in existing conditions are proven. A delay within the prescrip-

[7]While adverse possession of a land under a claim of ownership for the period fixed by law is ineffective against a torrens title, this is true where there are no intervening rights of third persons which may be affected or prejudiced by a decision directing the return of the land to the registered owner or his successor-in-interest. Where rights of third persons who acted in good faith would be affected, although the legal defense of prescription does not lie against the title of the registered owner, an equitable one may lie in their favor under the particular facts and circumstances and that is the equitable defense of laches. (see Javier vs. Concepcion, 94 SCRA 212 [1979].) Thus, a registered landowner may lose his right to recover the possession of his registered property by reason of laches. (Eduarte vs. Court of Appeals, 311 SCRA 18 [1999]; Baluyot vs. Court of Appeals, 311 SCRA 29 [1999].)

tive period is sanctioned by law and is not considered to be delay that would bar relief. (Agra vs. Philippine National Bank, 309 SCRA 509 [1999]; De Castro vs. Court of Appeals, 384 SCRA 607 [2002]; G.F. Equity, Inc. vs. Valenzuela, 462 SCRA 466 [2005].)

**ART. 1434. When a person who is not the owner of a thing sells or alienates and delivers it, and later the seller or grantor acquires title thereto, such title passes by operation of law to the buyer or grantee.**

### Estoppel against vendor who subsequently acquires title.

Under the doctrine of estoppel by deed, a person who sells property to which he did not have title cannot deny the validity of the sale, if he should later acquire valid title thereto in his own name. The sale is validated when the vendor becomes the owner of the property. (Llacer vs. Muñoz, 12 Phil. 328 [1909]; Estogue vs. Pajimula, 24 SCRA 59 [1968].) In such case, title is recognized in the vendee by operation of law (see Art. 712.), because the vendor's subsequent acquisition of the thing sold or alienated would have the effect of making his conveyance valid thru estoppel by deed. (Molina vs. Court of Appeals, 109 Phil. 709 [1960].)

The purchaser is also deemed a purchaser in good faith. (see Inquimboy vs. Vda. de Cruz, 108 Phil. 1054 [1960]; also Bucton vs. Gabar, 55 SCRA 499 [1974].)

**ART. 1435. If a person in representation of another sells or alienates a thing, the former cannot subsequently set up his own title as against the buyer or grantee.**

### Estoppel against agent who sells for another.

Under this article, the person who acted as agent or representative of another in the sale or alienation of a thing, cannot question the validity of the transfer and claim title to the thing sold or alienated as against the buyer or grantee.

**ART. 1436. A lessee or a bailee is estopped from asserting title to the thing leased or received, as against the lessor or bailor.**

### Estoppel against tenant or bailee.

(1) A tenant will not be heard to dispute his landlord's title. (see Lizada vs. Omanan, 59 Phil. 547 [1934].) This estoppel applies even though the lessor had no title at the time the relation of lessor and lessee was created, and may be asserted not only by the original lessor, but also by those who succeed to his title. (Geminiano vs. Court of Appeals, 259 SCRA 344 [1996].)

Under the Rules of Court, conclusive presumptions include: "(b) The tenant is not permitted to deny the title of his landlord at the time of the commencement of the relation of landlord and tenant between them." (Sec. 3-b, Rule 131, Rules of Court.)

(2) Similarly, a bailee in commodatum (see Art. 1933.), *depositum* (see Art. 1962.), or pledge (see Art. 2093.) is estopped to assert title to the thing received as against the bailor.

**ART. 1437. When in a contract between third persons concerning immovable property, one of them is misled by a person with respect to the ownership or real right over the real estate, the latter is precluded from asserting his legal title or interest therein, provided all these requisites are present:**

**(1) There must be fraudulent representation or wrongful concealment of facts known to the party estopped;**

**(2) The party precluded must intend that the other should act upon the facts as misrepresented;**

**(3) The party misled must have been unaware of the true facts; and**

**(4) The party defrauded must have acted in accordance with the misrepresentation.**

### Estoppel against owner of immovable.

The rule is well-settled that the title to land or real property may pass by an equitable estoppel which is effectual to take the title to land from one person and vest it in another where justice requires that such action be done. Thus, by intentional misrepresentation, misleading conduct, or wrongful concealment, a person may preclude himself from asserting his legal title to land or from enforcing an encumbrance on, or maintaining an interest in, real estate. (28 Am. Jur. 2d. 723-724.)

The requisites enumerated in Article 1437 must be present in order to invoke estoppel concerning immovable property.

EXAMPLE:

X, owner, of a parcel of land, and Y made it appear in a document that Y is the real owner. Y or his successors-in-interest cannot afterwards assert ownership over the land as it cannot be said that Y was misled by the false representation being a party to the same.

X would have been estopped from claiming any right over the property had it been sold by Y to Z, a purchaser in good faith. (see Cristobal vs. Gomez, *supra.*)

ILLUSTRATIVE CASE:

*Purchaser from the true owner had knowledge of the previous sale of the same property to another, made by one held out as owner by the true owner.*

*Facts:* B purchased S's hereditary interest in an undivided estate. With the connivance of B, S held himself out as still the owner of that interest and succeeded in inducing C to purchase said interest from S. Subsequently, B sold the same interest to D who had knowledge of the previous sale made by S to C.

*Issue:* Who has a better right to the property sold, C or D?

*Held:* C. Where the true owner of real property for, however short a time holds out another or, with knowledge of his own right, allows another to appear as the owner of, or as having full power of disposition over the property, and innocent third persons are thus led into dealing with such apparent owner, the true owner cannot, to the detriment of such third persons, be permitted to nullify the act of the apparent owner. *(Hernaez vs. Hernaez, 32 Phil. 214 [1915].)*

**ART. 1438. One who has allowed another to assume apparent ownership of personal property for the purpose of making any transfer of it, cannot, if he received the sum for which a pledge has been constituted, set up his own title to defeat the pledge of the property, made by the other to a pledgee who received the same in good faith and for value.**

## Estoppel by acceptance of benefits.

Estoppel is frequently based upon the acceptance and retention by one having knowledge or notice of the facts, of benefits from a transaction, contract, instrument regulation, or statute which he might have rejected or contested. It has been said that the case is

referable, when no fraud, either actual or constructive, is involved to the principles of ratification (see Arts. 1317, 1403[1], 1405.) rather than to those of estoppel. The result produced, however, is clearly the same, and the distinction is not usually made. Such estoppel precludes one who accepts the benefits from repudiating the accompanying or resulting obligation, and may operate to prevent a party from profiting by his own wrong. (28 Am. Jur. 2d. 677-678.)

Estoppel by the acceptance of benefits finds application in many different fields and under a wide variety of circumstances. *(Ibid.)* An example is provided in the above article.

(1) It has been held that where an employee had accepted the benefits accruing from the abolition of his office by enjoying his unused vacation and sick leave and receiving the corresponding gratuity, he is estopped from questioning its validity or deemed to have waived the right to contest the same. (Magana vs. Auditor General, 107 Phil. 900 [1960].)

(2) Similarly, an employee of a bank was held estopped from questioning his retirement before reaching the age of 65, where it appears that he not only failed to appeal his separation to the Appeals Committee in the said bank but he even wrote the bank that he was not making any appeal, and, in fact, has already received his separation pay. (De Leon vs. Phil. National Bank, 81 SCRA 756 [1978].)

(3) In a case, the appointees, having accepted the acting appointments (as acting Mayor, Vice-Mayor, and councilors of a newly created municipality) extended to them without any protest or reservation, and having acted thereunder for a considerable time, the court ruled that they "cannot now be heard to say that such appointments were, in reality, permanent and that, by reason of their being so, they could not be removed, except for cause, before the end of the term for which they were supposedly appointed." (Cabiling vs. Pabualan, 14 SCRA 274 [1965].)

(4) But the plaintiff's acceptance of the offer of settlement of the defendant should not be deemed a waiver of the action where his acceptance was conditional and the condition was not accepted. The doctrine of estoppel cannot, therefore, be slapped against him. (Switzerland Gen. Ins. Co., Ltd. vs. Java Pacific & Hoegh Lines, 16 SCRA 916 [1966].)

(5) Quitclaims executed by laborers are commonly frowned upon as contrary to public policy and ineffective to bar claims for

the full measure of the workers' rights under the law. Acceptance of benefits such as separation pay by employees does not amount to estoppel. (Blue Bar Coconut Phils., Inc. vs. National Labor Relations Commission, 208 SCRA 371 [1992].)

ILLUSTRATIVE CASES:

1. *The heirs, after securing approval of a project of partition and its execution, question jurisdiction of probate court to order delivery of property in their possession.*

*Facts:* In an intestate estate, a project of partition was approved by the court and thus became a judgement of the court. As the administrator refused to turn over to H, etc. (heirs) their shares, they moved for and received from the probate court an order for the execution of the partition, complaining bitterly that the execution was long overdue. The distribution of the estate in pursuance of the partition had fully been carried out and H, etc. had received the property assigned to them.

H, etc. now question the jurisdiction of the court to issue an order directing them to deliver to the administrator a certain parcel of land in their possession and to which they assert exclusive ownership.

*Issue:* Are H, etc., in estoppel to question the validity of the partition?

*Held:* Yes. In the face of what they have done, they are estopped from attacking the validity of the partition, or any part of it. A party cannot, in law and in good conscience, be allowed to reap the fruits of a partition, agreement or judgment and repudiate what does not suit him. To all intents and purposes, the property was in *custodia legis*. What H, etc. could have done was to ask for a reconsideration or modification of the partition on the grounds of fraud, mistake, etc. if they could substantiate such allegations. They cannot attack the partition collaterally, as they are trying to do in this case. *(Borja Vda. De Torres vs. Encarnacion, 89 Phil. 678 [1951].)*

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2. *A licensee, after availing of the benefits of a law, questions its validity.*

*Facts*: P, on several occasions, exported large amounts of scrap metals for which it paid license fees and royalties to the Sugar Quota Office. The exportation was allowed by virtue of a permit of the President of the Philippines acting under the authority of C.A. No. 728.

P filed a claim for refund of said license fees and royalties with the Auditor General claiming that the Act was inoperative and unconstitutional.

*Issue:* Is P estopped from setting up the invalidity of the Act in question?

*Held:* Yes, it appearing that it had acted thereon, or invoked the benefits deriving therefrom when it applied for the exportation of scrap metals as provided for in said Act. It has been held that (citing Cooley's Const. Limitations, Vol. 1, pp. 369-370.) "a person who obtains a license under a law and seeks for a time to enjoy the benefits thereof, cannot afterwards, and when the license is sought to be revoked, question the constitutionality of the act." *(Philippine Scrappers, Inc. vs. Auditor General, 96 Phil. 454 [1955].)*

**ART. 1439. Estoppel is effective only as between the parties thereto or their successors in interest.**

## Persons affected by estoppel.

(1) An estoppel operates only on the parties to the transaction out of which it arises and their privies notwithstanding that the latter are not personally liable on the covenants creating the estoppel. Conversely, a stranger to a transaction is neither bound by, nor in a position to take advantage of, an estoppel arising therefrom. (Resuena vs. Court of Appeals, 454 SCRA 42 [2005].)

The reason for the latter rule is that mutuality is an essential element of estoppel; and estoppel must bind both parties or neither is bound. Thus, a grantor is not estopped by his deed as against one who is neither a party thereto nor in privity with a party. (28 Am. Jur. 2d. 774-775; Belfren vs. Escudero, 99 Phil. 643 [1956].) If anybody may be heard to challenge the application of the doctrine of estoppel, it is only the party against whom it may be invoked. (Castrillo vs. Court of Appeals, 10 SCRA 549 [1964].)

(2) Well-settled is the rule that if a private corporation intentionally or negligently clothes its officers or agents with apparent power to perform acts for it, the corporation will be estopped to deny that such apparent authority is real as to innocent third persons dealing in good faith with such officers or agents. (Francisco vs. GSIS, 7 SCRA 577 [1963]; Phil. National Bank vs. Court of Appeals, 94 SCRA 357 [1979].)

(3) The government, however, is not estopped by the mistake or error on the part of its officials or agents. (Luciano vs. Estrella, 34 SCRA 769 [1970], and other cases, *supra.*)

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# PREFACE

This volume which is the fifth edition of the original work is primarily intended to serve as a basic text for law students in OBLIGATIONS AND CONTRACTS. It includes the Civil Code provisions on natural obligations and estoppel.

Leading cases illustrating the practical application of legal provisions are concisely reduced to their bare essentials. In some cases, the pertinent rulings are reproduced substantially in their original form with appropriate headings to indicate the specific points or principles of law being discussed. Numerous examples typical of everyday life are also utilized to facilitate understanding. Practically, all the available cases decided by the Supreme Court on the subject up to the preparation of this book have been included, or at least cited under the pertinent articles of the Civil Code for ready reference.

The authors hope that this humble work will prove useful to those for whom it has been written.

**HECTOR S. DE LEON**

**HECTOR M. DE LEON, JR.**

June 2010

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