

**DOMINGO GONZALO, PETITIONER, VS. JOHN TARNATE, JR.,
RESPONDENT.***G.R. No. 160600. January 15, 2014*

Ponente: BERSAMIN, J.

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The doctrine of *in pari delicto*, which stipulates that the guilty parties to an illegal contract are not entitled to any relief, cannot prevent a recovery if doing so violates the public policy against unjust enrichment.

Antecedents

After the Department of Public Works and Highways (DPWH) had awarded on July 22, 1997 the contract for the improvement of the Sadsadan-Maba-ay Section of the Mountain Province-Benguet Road in the total amount of P7,014,963.33 to his company, Gonzalo Construction,[1] petitioner Domingo Gonzalo (Gonzalo) subcontracted to respondent John Tarnate, Jr. (Tarnate) on October 15, 1997, the supply of materials and labor for the project under the latter's business known as JNT Aggregates. Their agreement stipulated, among others, that Tarnate would pay to Gonzalo eight percent and four percent of the contract price, respectively, upon Tarnate's first and second billing in the project.[2]

In furtherance of their agreement, Gonzalo executed on April 6, 1999 a deed of assignment whereby he, as the contractor, was assigning to Tarnate an amount equivalent to 10% of the total collection from the DPWH for the project. This 10% retention fee (equivalent to P233,526.13) was the rent for Tarnate's equipment that had been utilized in the project. In the deed of assignment, Gonzalo further authorized Tarnate to use the official receipt of Gonzalo Construction in the processing of the documents relative to the collection of the 10% retention fee and in encashing the check to be issued by the DPWH for that purpose.[3] The deed of assignment was submitted to the DPWH on April 15, 1999. During the processing of the documents for the retention fee, however, Tarnate learned that Gonzalo had unilaterally rescinded the deed of assignment by means of an affidavit of cancellation of deed of assignment dated April 19, 1999 filed in the DPWH on April 22, 1999;[4] and that the disbursement voucher for the 10% retention fee had then been issued in the name of Gonzalo, and the retention fee released to him.[5]

Tarnate demanded the payment of the retention fee from Gonzalo, but to no avail. Thus, he brought this suit against Gonzalo on September 13, 1999 in the Regional Trial Court (RTC) in Mountain Province to recover the retention fee of P233,526.13, moral and exemplary damages for breach of contract, and attorney's fees.[6]

In his answer, Gonzalo admitted the deed of assignment and the authority given therein to Tarnate, but averred that the project had not been fully implemented because of its cancellation by the DPWH, and that he had then revoked the deed of assignment. He insisted that the assignment could not stand independently due to its being a mere product of the subcontract that had been based on his contract with the DPWH; and that Tarnate, having been fully aware of the illegality and ineffectuality of the deed of assignment from the time of its execution, could not go to court with unclean hands to invoke any right based on the invalid deed of assignment or on the product of such deed of assignment.[7]

Ruling of the RTC

On January 26, 2001, the RTC, opining that the deed of assignment was a valid and binding contract, and that Gonzalo must comply with his obligations under the deed of assignment, rendered judgment in favor of Tarnate as follows:

WHEREFORE, premises considered and as prayed for by the plaintiff, John Tarnate, Jr. in his Complaint for Sum of Money, Breach of Contract With Damages is hereby RENDERED in his favor and against the above-named defendant Domingo Gonzalo, the Court now hereby orders as follows:

- Defendant Domingo Gonzalo to pay the Plaintiff, John Tarnate, Jr., the amount of TWO HUNDRED THIRTY THREE THOUSAND FIVE HUNDRED TWENTY SIX and 13/100 PESOS (P233,526.13) representing the rental of equipment;

- Defendant to pay Plaintiff the sum of THIRTY THOUSAND (P30,000.00) PESOS by way of reasonable Attorney's Fees for having forced/compelled the plaintiff to litigate and engage the services of a lawyer in order to protect his interest and to enforce his right. The claim of the plaintiff for attorney's fees in the amount of FIFTY THOUSAND PESOS (P50,000.00) plus THREE THOUSAND PESOS (P3,000.00) clearly appears to be unconscionable and therefore reduced to Thirty Thousand Pesos (P30,000.00) as aforesaid making the same to be reasonable;

- Defendant to pay Plaintiff the sum of FIFTEEN THOUSAND PESOS (P15,000.00) by way of litigation expenses;

- Defendant to pay Plaintiff the sum of TWENTY THOUSAND PESOS (P20,000.00) for moral damages and for the breach of contract; and

- To pay the cost of this suit.

Award of exemplary damages in the instant case is not warranted for there is no showing that the defendant acted in a wanton, fraudulent, reckless, oppressive or malevolent manner analogous to the case of Xentrex Automotive, Inc. vs. Court of Appeals, 291 SCRA 66.[8]

Gonzalo appealed to the Court of Appeals (CA).

Decision of the CA

On February 18, 2003, the CA affirmed the RTC.[9]

Although holding that the subcontract was an illegal agreement due to its object being specifically prohibited by Section 6 of Presidential Decree No. 1594; that Gonzalo and Tarnate were guilty of entering into the illegal contract in violation of Section 6 of Presidential Decree No. 1594; and that the deed of assignment, being a product of and dependent on the subcontract, was also illegal and unenforceable, the CA did not apply the doctrine of in pari delicto, explaining that the doctrine applied only if the fault of one party was more or less equivalent to the fault of the other party. It found Gonzalo to be more guilty than Tarnate, whose guilt had been limited to the execution of the two illegal contracts while Gonzalo had gone to the extent of violating the deed of assignment. It declared that the crediting of the 10% retention fee equivalent to P233,256.13 to his account had unjustly enriched Gonzalo; and ruled, accordingly, that Gonzalo should reimburse Tarnate in that amount because the latter's equipment had been utilized in the project.

Upon denial of his motion for reconsideration,[10] Gonzalo has now come to the Court to seek the review and reversal of the decision of the CA.

Issues

Gonzalo contends that the CA erred in affirming the RTC because: (1) both parties were in *pari delicto*; (2) the deed of assignment was void; and (3) there was no compliance with the arbitration clause in the subcontract.

Gonzalo submits in support of his contentions that the subcontract and the deed of assignment, being specifically prohibited by law, had no force and effect; that upon finding both him and Tarnate guilty of violating the law for executing the subcontract, the RTC and the CA should have applied the rule of *in pari delicto*, to the effect that the law should not aid either party to enforce the illegal contract but should leave them where it found them; and that it was erroneous to accord to the parties relief from their predicament.[11]

Ruling

We deny the petition for review, but we delete the grant of moral damages, attorney's fees and litigation expenses.

There is no question that every contractor is prohibited from subcontracting with or assigning to another person any contract or project that he has with the DPWH unless the DPWH Secretary has approved the subcontracting or assignment. This is pursuant to Section 6 of Presidential Decree No. 1594, which provides:

Section 6. Assignment and Subcontract. – The contractor shall not assign, transfer, pledge, subcontract or make any other disposition of the contract or any part or interest therein except with the approval of the Minister of Public Works, Transportation and Communications, the Minister of Public Highways, or the Minister of Energy, as the case may be. Approval of the subcontract shall not relieve the main contractor from any liability or obligation under his contract with the Government nor shall it create any contractual relation between the subcontractor and the Government.

Gonzalo, who was the sole contractor of the project in question, subcontracted the implementation of the project to Tarnate in violation of the statutory prohibition. Their subcontract was illegal, therefore, because it did not bear the approval of the DPWH Secretary. Necessarily, the deed of assignment was also illegal, because it sprung from the subcontract. As aptly observed by the CA:

x x x. The intention of the parties in executing the Deed of Assignment was merely to cover up the illegality of the sub-contract agreement. They knew for a fact that the DPWH will not allow plaintiff-appellee to claim in his own name under the Sub-Contract Agreement.

Obviously, without the Sub-Contract Agreement there will be no Deed of Assignment to speak of. The illegality of the Sub-Contract Agreement necessarily affects the Deed of Assignment because the rule is that an illegal agreement cannot give birth to a valid contract. To rule otherwise is to sanction the act of entering into transaction the object of which is expressly prohibited by law and thereafter execute an apparently valid contract to subterfuge the illegality. The legal proscription in such an instance will be easily rendered nugatory and meaningless to the prejudice of the general public.[12]

Under Article 1409 (1) of the Civil Code, a contract whose cause, object or purpose is contrary to law is a void or inexistent contract. As such, a void contract cannot produce a valid one.[13] To the same effect is Article 1422 of the Civil Code, which declares that “a contract, which is the direct result of a previous illegal contract, is also void and inexistent.”

We do not concur with the CA's finding that the guilt of Tarnate for violation of Section 6 of Presidential Decree No. 1594 was lesser than that of Gonzalo, for, as the CA itself observed, Tarnate had voluntarily entered into the agreements with Gonzalo.[14] Tarnate also admitted that he did not participate in the bidding for the project because he knew that he was not authorized to contract with the DPWH.[15] Given that Tarnate was a businessman who had represented himself in the subcontract as “being financially and organizationally sound and established, with the necessary personnel and equipment for the performance of the project,”[16] he justifiably

presumed to be aware of the illegality of his agreements with Gonzalo. For these reasons, Tarnate was not less guilty than Gonzalo.

According to Article 1412 (1) of the Civil Code, the guilty parties to an illegal contract cannot recover from one another and are not entitled to an affirmative relief because they are in *pari delicto* or in equal fault. The doctrine of in *pari delicto* is a universal doctrine that 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 the 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.[17]

Nonetheless, the application of the doctrine of in *pari delicto* is not always rigid. An accepted exception arises when its application contravenes well-established public policy.[18] In this jurisdiction, public policy has been defined as “that principle of the 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.”[19]

Unjust enrichment exists, according to *Hulst v. PR Builders, Inc.*,[20] “when a person unjustly retains a benefit at the loss of another, or when a person retains money or property of another against the fundamental principles of justice, equity and good conscience.” The prevention of unjust enrichment is a recognized public policy of the State, for Article 22 of the Civil Code explicitly provides that “[e]very 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.” It is well to note that Article 22 “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; designed to indicate certain norms that spring from the fountain of good conscience; 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.”[21]

There is no question that Tarnate provided the equipment, labor and materials for the project in compliance with his obligations under the subcontract and the deed of assignment; and that it was Gonzalo as the contractor who received the payment for his contract with the DPWH as well as the 10% retention fee that should have been paid to Tarnate pursuant to the deed of assignment.[22] Considering that Gonzalo refused despite demands to deliver to Tarnate the stipulated 10% retention fee that would have compensated the latter for the use of his equipment in the project, Gonzalo would be unjustly enriched at the expense of Tarnate if the latter was to be barred from recovering because of the rigid application of the doctrine of in *pari delicto*. The prevention of unjust enrichment called for the exception to apply in Tarnate’s favor. Consequently, the RTC and the CA properly adjudged Gonzalo liable to pay Tarnate the equivalent amount of the 10% retention fee (i.e., P233,526.13).

Gonzalo sought to justify his refusal to turn over the P233,526.13 to Tarnate by insisting that he (Gonzalo) had a debt of P200,000.00 to Congressman Victor Dominguez; that his payment of the 10% retention fee to Tarnate was conditioned on Tarnate paying that debt to Congressman Dominguez; and that he refused to give the 10% retention fee to Tarnate because Tarnate did not pay to Congressman Dominguez.[23] His justification was unpersuasive, however, because, firstly, Gonzalo presented no proof of the debt to Congressman Dominguez; secondly, he did not competently establish the agreement on the condition that supposedly bound Tarnate to pay to Congressman Dominguez;[24] and, thirdly, burdening Tarnate with Gonzalo’s personal debt to Congressman Dominguez to be paid first by Tarnate would constitute another case of unjust enrichment.

The Court regards the grant of moral damages, attorney’s fees and litigation expenses to Tarnate to be inappropriate. We have ruled that no damages may be recovered under a void contract, which, being nonexistent,

produces no juridical tie between the parties involved.[25] It is notable, too, that the RTC and the CA did not spell out the sufficient factual and legal justifications for such damages to be granted.

Lastly, the letter and spirit of Article 22 of the Civil Code command Gonzalo to make a full reparation or compensation to Tarnate. The illegality of their contract should not be allowed to deprive Tarnate from being fully compensated through the imposition of legal interest. Towards that end, interest of 6% per annum reckoned from September 13, 1999, the time of the judicial demand by Tarnate, is imposed on the amount of P233,526.13. Not to afford this relief will make a travesty of the justice to which Tarnate was entitled for having suffered too long from Gonzalo's unjust enrichment.

WHEREFORE, we AFFIRM the decision promulgated on February 18, 2003, but DELETE the awards of moral damages, attorney's fees and litigation expenses; IMPOSE legal interest of 6% per annum on the principal of P233,526.13 reckoned from September 13, 1999; and DIRECT the petitioner to pay the costs of suit.

SO ORDERED.

Sereno, C.J., Leonardo-De Castro, Villarama, Jr., and Reyes, JJ., concur.

[1] Records, pp. 88-90.

[2] Id. at 26-28.

[3] Id. at 5-6.

[4] Id. at 8.

[5] Id. at 9-10.

[6] Id. at 1-4.

[7] Id. at 50-52.

[8] Id. at 110-120.

[9] Rollo, pp. 16-34; penned by Associate Justice Remedios A. Salazar-Fernando, and concurred in by Associate Justice Ruben T. Reyes (later Presiding Justice and a Member of the Court, but already retired) and Associate Justice Edgardo F. Sundiam (retired/deceased).

[10] Id. at 36.

[11] Id. at 8-12.

[12] Rollo, p. 30.

[13] Nool v. Court of Appeals, G.R. No. 116635, July 24, 1997, 276 SCRA 149, 157.

[14] Rollo, p. 31-32.

[15] TSN, July 24, 2000, pp. 23-24.

[16] Records, p. 26.

[17] Rellosa v. Gaw Chee Hun, 93 Phil. 827, 831 (1953).

[18] Pajuyo v. Court of Appeals, G.R. No. 146364, June 3, 2004, 430 SCRA 492, 515.

[19] Avon Cosmetics, Incorporated v. Luna, G.R. No. 153674, December 20, 2006, 511 SCRA 376, 393-394.

[20] G.R. No. 156364, September 3, 2007, 532 SCRA 74.

[21] Id. at 96.

[22] TSN, August 28, 2000, pp. 44, 64, 70, and 71.

[23] Id. at 46-50.

[24] Id. at 51-54.

[25] Hulst v. PR Builders, Inc., supra note 20, at 94-95; Menchavez v. Teves, Jr., G.R. No. 153201, January 26, 2005, 449 SCRA 380, 398-399.

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