

D.M. RAGASA ENTERPRISES, INC., PETITIONER, V. BANCO DE ORO, INC. (FORMERLY EQUITABLE PCI BANK, INC.), RESPONDENT.*G.R. No. 190512. June 20, 2018*Read online (full-text search, related cases, audio case brief): <https://batas.org/library/g-r-no-190512/>**CAGUIOA, J:**

Before the Court is a Petition for Review[1] on Certiorari (Petition) under Rule 45 of the Rules of Court (Rules) filed by petitioner D.M. Ragasa Enterprises, Inc., (Ragasa) against respondent Banco de Oro, Inc.,[2] formerly Equitable PCI Bank, Inc. (bank), assailing the Decision[3] dated March 27, 2009 (questioned Decision) and Resolution[4] dated November 25, 2009, both of the Court of Appeals (CA) Special Thirteenth (13th) Division and Former Special Thirteenth Division, respectively, in CA-G.R. CV. No. 88322.

The CA reversed and set aside the rulings in favor of Ragasa of the Regional Trial Court (RTC) of Quezon City, Branch 216, in its Decision dated April 4, 2006[5] and Order dated October 3, 2006[6] (denying the corresponding Motion for Reconsideration) in Civil Case No. Q-02-46341.

The Facts

On January 30, 1998, Ragasa and then Equitable Banking Corporation (Equitable Bank) executed a Contract of Lease[7] (Lease Contract), as lessor and lessee, respectively, over the ground and second floors of a commercial building located at 175 Tomas Morato Avenue corner Scout Castor, Quezon City (subject premises), for a period of five years, commencing on February 1, 1998[8] up to January 31, 2003[9], with a monthly rental of P122,607.00.[10] The pertinent provisions of the Lease Contract state, viz.:

2. The TERM of this Lease shall be for a period of five (5) years, commencing on February 1, 1998. x x x

3. The TENANT shall pay a monthly rental of ONE HUNDRED TWENTY TWO THOUSAND SIX HUNDRED SEVEN (122,607) pesos based on P463.16 per square meter per month inclusive of Value Added Tax and withholding tax and payable in advance in the first five days of the month, that is 1st to 5th of every month. An annual increase of 10% shall be applied during the term of the lease.

4. The failure to pay two consecutive monthly rentals within the first five (5) days of any month, as stated in No. 3, shall automatically terminate this Contract, without need of any further notice to the TENANT. The LESSOR is hereby authorized, and has the right to show the premises to prospective tenants, and within five (5) days following the last day of the grace period stated in No. 3, the TENANT shall vacate the premises without the need of the usual judicial proceedings, and/or the LESSOR shall padlock the premises until the TENANT settles his obligations. The TENANT agrees to this padlocking as a sign of his good faith in his compliance with No. 3 of this Contract and the LESSOR is not liable or answerable for any damage that the TENANT may incur or suffer due to his non-entrance to the premises, or the LESSOR may confiscate any property found in the premises equivalent to the unpaid rental, penalty, and interests thereto, as guaranty and/or pledge, and can be retrieved anytime upon full payment of his accounts but must not be for more than three (3) months from the date of default [;] otherwise, the confiscated property or properties shall become permanently owned by the LESSOR as partial payment of his unpaid rentals, penalties and interests, and in case of any unpaid balance, the TENANT is still liable.

x x x x

7. The parties hereby covenant and agree upon the signing of this Contract of Lease that [the] TENANT shall pay to the LESSOR or his representative, the amount of SEVEN HUNDRED THIRTY FIVE THOUSAND SIX HUNDRED FORTY TWO (P735,642) pesos, Philippine Currency, P367,821 as three months advanced rental, and P367,821 as three months deposit, which deposit shall be refunded to the TENANT only upon termination of this Lease, that is, after expiration of the lease, paid occupancy of the said premises, and after vacating the same and also after deducting the unpaid water bills[,] if any, electric bills, extraordinary wear and tear of the premises, losses and breakages of the premises, and other damages sustained by the LESSOR.

8. The TENANT voluntarily binds himself and agrees to the following without any coercion or force by the LESSOR;

x x x x

m) The full deposit shall be forfeited in favor of the LESSOR upon non-compliance of the Term of the Contract of Lease by the TENANT, and cannot be applied to Rental;

n) To pay a penalty of 3% of the monthly rental, for every month of delay of payment of the monthly rental, [with] a fraction of the month x x x considered [as] one month;

p) Breach or non-compliance of any of the provisions of this Contract, especially non-payment of two consecutive monthly rentals on time, shall mean the termination of this Contract, and within five (5) days from the date of breach, non-compliance, or default, the TENANT shall vacate the premises quietly and peacefully without need of the required judicial proceedings. If he does not vacate the premises, the TENANT has agreed that the LESSOR has no liability whatsoever due to the padlocking of the same;

x x x x

10. In the event that a Court Litigation has been resorted to by the LESSOR or LESSEE, due to non-compliance of any of the foregoing provisions, the aggrieved party shall be paid by the other party, no less than fifteen thousand (P15,000) pesos, Philippine Currency, for Attorney's fees, and other damages that the honorable court may allow; the cost of litigations shall be born[e] or paid by the party in fault, or in default. All unpaid accounts and obligations of the TENANT shall earn interest or bear interest at the rate of 14% per annum or at the allowable rate of interest from the date of default. The legal suits shall be brought in the town of Quezon City.[11]

Pursuant to the Lease Contract, Equitable Bank paid the amounts of P367,821.00 representing three months advance rentals, and P367,821.00 representing three months rentals as security deposit.[12]

Meanwhile, Equitable Bank entered into a merger with Philippine Commercial International Bank (PCI Bank) thereby forming Equitable PCI Bank, Inc.[13] The latter would eventually, pending the present case, merge with Banco de Oro, Inc. to form the respondent bank.[14]

As a result of the merger, the bank closed and joined the branches of its constituent banks which were in close proximity with each other as maintaining said branches would be impractical.[15] One of the branches which had to be closed is the branch located in the subject premises.[16]

For this reason, the bank sent a notice dated May 28, 2001, informing Ragasa that the former was pre-terminating their Lease Contract effective June 30, 2001 (Notice of Pre-termination)[17]. Ragasa responded with a demand letter dated June 20, 2001[18] for payment of monthly rentals for the remaining term of the Lease Contract from July 1, 2001 to January 31, 2003 totaling P3,146,596.42, inasmuch as there is no express provision in the Lease Contract allowing pre-termination.[19] The bank countered, through a letter dated June 26, 2001,[20] that its only

liability for pre-terminating the contract is the forfeiture of its security deposit pursuant to item 8(m) of the Lease Contract.[21] On June 30, 2001, the bank vacated the subject premises without heeding Ragasa's demand for payment.

After sending two more reiterative demand letters,[22] which were both ignored by the bank, Ragasa finally filed on March 11, 2002 with the RTC the Complaint for Collection of Sum of Money (amounting to P3,146,596.42 representing the monthly rentals under the Lease Contract for the period July 1, 2001 to January 31, 2003) and Damages. Ragasa argued that under the Lease Contract, the forfeiture of the bank's security deposit does not exempt it from payment of the rentals for the remaining term of the lease because the bank's act of pre-terminating the contract was a major breach of its terms. Moreover, item 8(m) expressly provides that the security deposit shall not be applied to the rentals.

In its Answer filed on April 26, 2002, the bank argued, in gist, that item 8(m) of the Lease Contract is actually a penalty clause which, in line with Article 1226[23] of the Civil Code, takes the place of damages and interests in case of breach. Hence, for breaching the Lease Contract by pre-terminating the same, the bank is liable to forfeit its security deposit in favor of Ragasa but would not be liable for rentals corresponding to the remaining life of the Contract. Moreover, the bank is not liable for the penalty at the rate of 3% under item 8(n) of the Lease Contract because the bank paid the due rentals up to the time it pre-terminated the same.[24]

Ruling of the RTC

The RTC ruled in Ragasa's favor in a Decision dated April 4, 2006, the dispositive portion of which reads:

WHEREFORE, the Court finds that plaintiff has established its case against defendant by preponderance of evidence and judgment is hereby rendered ordering defendant Equitable PCI Bank, Inc. to pay plaintiff the following:

- The amount of Php 3,146,596.42 Philippine Currency, representing the monthly rentals from July 1, 2001 to January 31, 2003;
- A penalty of 3% of the monthly rental for every month of delay;
- An interest of 14% per annum on the full amount due until fully paid;
- Attorney's fees in the amount of Php 30,000.00; and
- Costs of litigation.

Defendant's Counterclaim is dismissed.

SO ORDERED.[25]

The RTC held that the bank may not unilaterally pre-terminate the Lease Contract; hence, it is still liable to pay the rentals for the remaining duration of the said contract. Likewise, in addition to item 8(m) of the Lease Contract providing for the forfeiture of the bank's security deposit, item 8(n), another penalty clause providing for additional 3% of the monthly rental for each month of delay in payment, also applies. Finally, pursuant to Section 10, an interest of 14% per annum on the amount due was awarded.

The bank filed a Motion for Reconsideration which was denied by the RTC in its Order dated October 3, 2006.[26]

On October 23, 2006, the bank filed a Notice of Appeal to the CA, arguing that the Lease Contract was automatically terminated by the act of the bank in pre-terminating the lease or based on the provisions of the

Lease Contract, and that upon termination of the lease, the bank has been released from its future contractual obligations including the payment of "future rentals." [27]

Ruling of the CA

In the questioned Decision dated March 27, 2009, the CA granted the bank's appeal and reversed and set aside the RTC's ruling, disposing of the case as follows:

WHEREFORE, the appeal is hereby GRANTED. The ruling of the trial court is hereby REVERSED and SET ASIDE. The complaint is dismissed for lack of legal basis.

SO ORDERED. [28]

The CA ruled that the bank's failure to continue the Lease Contract until its expiration constituted a breach of its provision. As such, the Lease Contract was automatically terminated by virtue of item 8(p) thereof providing for its outright termination in case of breach of any of its provisions. Hence, there is no legal basis to hold the bank liable for payment of rentals for the unexpired period of the contract. However, the bank is liable to forfeit its security deposit pursuant to the penalty clause under item 8(m) of the contract. The CA ruled that to allow Ragasa to collect the value of the unexpired term of the lease plus penalty would constitute unjust enrichment.

Ragasa filed a Motion for Reconsideration of the questioned Decision, which the CA denied for lack of merit, in its Resolution dated November 25, 2009. [29]

Refusing to concede, Ragasa filed the present Petition on January 21, 2010 raising four main issues, namely:

Issues

- 1.) WHETHER OR NOT THE COURT OF APPEALS SERIOUSLY ERRED IN LAW IN GRANTING THE APPEAL OF RESPONDENT BANK AND IN DENYING THE MOTION FOR RECONSIDERATION OF THE PETITIONER WHICH IS CONTRARY TO ARTICLES 1170 AND 1308 OF THE NEW CIVIL CODE[.]
- 2.) WHETHER OR NOT THE COURT OF APPEALS SERIOUSLY ERRED IN LAW IN RULING THAT THE PENALTY CLAUSE APPLICABLE IN THE CASE IS ITEM NO. 8(m) OF THE CONTRACT, AND NOT ITEM 8(n) OF THE SAME CONTRACT[.]
- 3.) WHETHER OR NOT THE COURT OF APPEALS SERIOUSLY ERRED IN LAW IN RULING THAT THE SUBJECT CONTRACT HAD BEEN TERMINATED[.]
- 4.) WHETHER OR NOT THE COURT OF APPEALS SERIOUSLY ERRED IN LAW IN RULING THAT THE PETITIONER IS GUILTY OF UNJUST ENRICHMENT[.][30]

The fundamental issue that the Court is called upon to resolve is: What is the liability of the bank, if any, for its act of pre-terminating the Lease Contract?

At the outset, it is well to remember that a contract is the law between the parties. [31] Obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith. [32] The parties are allowed by law [33] to enter into stipulations, clauses, terms and conditions they may deem convenient which bind the parties as long as they are not contrary to law, morals, good customs, public order or public policy. [34]

The pertinent provisions of the Lease Contract are as follows:

2. The TERM of this Lease shall be for a period of five (5) years, commencing on February 1, 1998. x x x

x x x x

7. The parties hereby covenant and agree upon the signing of this Contract of Lease that [the] TENANT shall pay to the LESSOR or his representative, the amount of SEVEN HUNDRED THIRTY FIVE THOUSAND SIX HUNDRED FORTY TWO (P735,642) pesos, Philippine Currency, P367,821 as three months advanced rental, and P367,821 as three months deposit, which deposit shall be refunded to the TENANT only upon termination of this Lease, that is, after expiration of the lease, paid occupancy of the said premises, and after vacating the same and also after deducting the unpaid water bills[,] if any, electric bills, extraordinary wear and tear of the premises, losses and breakages of the premises, and other damages sustained by the LESSOR.

8. The TENANT voluntarily binds himself and agrees to the following without any coercion or force by the LESSOR;

x x x x

m) The full deposit shall be forfeited in favor of the LESSOR upon non-compliance of the Term of the Contract of Lease by the TENANT, and cannot be applied to Rental;

x x x x

p) Breach or non-compliance of any of the provisions of this Contract, especially non-payment of two consecutive monthly rentals on time, shall mean the termination of this Contract, and within five (5) days from the date of breach, non-compliance, or default, the TENANT shall vacate the premises quietly and peacefully without need of the required judicial proceedings. If he does not vacate the premises, the TENANT has agreed that the LESSOR has no liability whatsoever due to the padlocking of the same;

x x x x

10. In the event that a Court Litigation has been resorted to by the LESSOR or LESSEE, due to non-compliance of any of the foregoing provisions, the aggrieved party shall be paid by the other party, no less than fifteen thousand (P15,000) pesos, Philippine Currency, for Attorney's fees, and other damages that the honorable court may allow; the cost of litigations shall be born[e] or paid by the party in fault, or in default. All unpaid accounts and obligations of the TENANT shall earn interest or bear interest at the rate of 14% per annum or at the allowable rate of interest from the date of default. The legal suits shall be brought in the town of Quezon City.[35] (Underscoring supplied)

The foregoing stipulations are clear and show no contravention of law, morals, good customs, public order or public policy. As such, they are valid, and the parties' rights shall be adjudicated according to them, being the primary law between them. When the terms of the contract are clear and leave no doubt as to the intention of the contracting parties, the rule is settled that the literal meaning of its stipulations should control.[36]

In the case at bar, there is no question that the bank breached the Lease Contract. When it served upon Ragasa the Notice of Pre-termination effective June 30, 2001 and when it, indeed, vacated the subject premises on said date, the bank, in effect, breached item 2 of the Lease Contract, providing for a five-year term. It must be noted that the Lease Contract does not contain a pre-termination clause.

The Lease Contract has a specific provision in case of non-compliance of its "Term" — "a period of five (5) years, commencing on February 1, 1998," to wit:

8. The TENANT voluntarily binds himself and agrees to the following without any coercion or force by the LESSOR;

x x x x

m) The full deposit shall be forfeited in favor of the LESSOR upon non-compliance of the Term of the

Contract of Lease by the TENANT, and cannot be applied to Rental;[37]

The word "term" appears only in three instances, but in three forms, in the five-page Lease Contract. Firstly, "TERM" (a defined word as the letters are all capitalized) is used in item 2, as quoted above, to indicate the five-year period of the lease. Secondly, "Term" is used in item 8(m), as quoted above, and being with a capitalized initial letter it also indicates that it is a defined word. Lastly, it is provided in item 8(g) that the lessee voluntarily binds itself and agrees: "To pay from time to time, during the term of this Lease, all expenses such as salaries, wages, etc., if for business, all charges for telephone if any, and/or any such other services in the Leased Premises." [38]

Given the fact that in item 2 and item 8(g), the words "TERM" and "term" definitely refer to the period of the lease, the word "Term" in item 8(m) should likewise be understood to have the same meaning.

The word "Term" could not mean stipulation, provision, condition, covenant or clause as the word "term" can also be understood. In the default clauses of the Lease Contract, i.e., items 8(p) and 10, the word employed is "provisions." It is the word "provisions" which the parties intended to refer to any stipulation, condition, covenant or clause and not the word "term."

Consequently, the correct interpretation of the word "Term" in item 8(m) is that it refers to the period of the lease, and not to any other provision of the Lease Contract.

Article 1170 of the Civil Code mandates that 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.

Thus, having contravened the tenor of the Lease Contract regarding its term or period, the bank should be liable for damages. However, how much in damages should the bank be liable?

Generally, if the lessor or the lessee should not comply with their obligations, the aggrieved party may ask for either the rescission of the contract and indemnification for damages, or only the latter, allowing the contract to remain in force.[39]

In the present case, there is an express stipulation in item 8(p) of the Lease Contract that "[b]reach or non-compliance of any of the provisions of this Contract, especially non-payment of two consecutive monthly rentals on time, shall mean the termination of this Contract." [40]

The validity of an automatic termination clause such as the one quoted above is well-settled.

In *Manila Bay Club Corp. v. Court of Appeals* [41] (*Manila Bay Club Corp.*), the lease period agreed upon was from March 4, 1988 to March 4, 1998 but was short-lived because the private respondents therein unilaterally terminated the lease with the request that petitioner therein vacate the leased premises and peacefully surrender its possession for the failure, among others, to insure the leased building in violation of paragraph 22 of the lease contract between the parties therein.[42] The private respondents therein invoked the "Special Clause" as found in paragraph 19 of the said lease contract to justify their actions, to wit:

19. If the rental herein stipulated or any part thereof at any time, shall be in arrears or unpaid, or if the tenant shall at any time fail or neglect to perform or comply with any of the covenants, conditions, agreements or restrictions stipulated or if the tenant shall become bankrupt or insolvent or shall compound with his creditors, then and in any of such above cases, this lease contract shall become automatically terminated and cancelled and the said premises shall be peacefully vacated by the LESSEE for the LESSOR to hold and enjoy henceforth as if these presents have not been made and it shall be lawful for the LESSOR or any person duly authorized in his behalf, without any formal notice or demand to enter into and upon said leased premises or any part thereof without prejudice on the part of the LESSOR to exercise all rights on the contract of lease and

those given by law. And upon such cancellation of the contract, the LESSEE hereby grants the LESSOR the legal right to enter into and take possession of the leased premises as though the term of the leased contract has expired.[43]

The Court justified the validity of the above automatic termination clause, thus:

Certainly, there is nothing wrong if the parties to the lease contract agreed on certain mandatory provisions concerning their respective rights and obligations, such as the procurement of the insurance and rescission clause. For it is well to recall that contracts are respected as the law between the contracting parties, and may establish such stipulations, clauses, terms and conditions as they may want to include. As long as such agreements are not contrary to law, morals, good customs, public policy or public order they shall have the force of law between them.[44]

In *Riesenbeck v. Spouses Silvino Maceren, Jr. and Patricia Maceren*[45] (*Riesenbeck*), the Court observed:

The Contract of Lease was called off by respondents in virtue of Clauses No. 10[46] and No. 13[47] thereof to which the parties voluntarily bound themselves. In *Manila Bay Club Corp. v. Court of Appeals*,[48] this Court interpreted as requiring mandatory compliance by the parties a provision in a lease contract that failure or neglect to perform or comply with any of the covenants, conditions, agreements or restrictions stipulated shall result in the automatic termination and cancellation of the lease.

In accord with this ruling is *Peoples Industrial and Commercial Corp. v. Court of Appeals*[49] where the Court held that there is nothing wrong if the parties to a lease contract agreed on certain mandatory provisions concerning their respective rights and obligations, such as the procurement of insurance and the rescission clause. Thus –

[I]t is well to recall that contracts are respected as the law between the contracting parties, and they may establish such stipulations, clauses, terms and conditions as they may want to include. As long as such agreements are not contrary to law, morals, good customs, public policy or public order they shall have the force of law between them.

The foregoing legal truism finds equal potency in the case at bar. No doubt, the pre-termination was properly resorted to by respondents pursuant to Clause 10 of the Contract of Lease. Indeed, the law on obligations and contracts does not prohibit parties from entering into agreement providing that a violation of the terms of the contract would cause its cancellation even without judicial intervention.[50] This is what petitioner and respondents entered into, a lease contract with a stipulation that the contract is rescinded upon violation of its substantial provisions, which petitioner, does not deny having violated.[51]

Pursuant to the automatic termination clause of the Lease Contract, which is in furtherance of the autonomy characteristic of contracts, the Lease Contract was terminated upon its unauthorized pre-termination by the bank on June 30, 2001. Ragasa is, thus, precluded from availing of the second option which is to claim damages by reason of the breach and allow the lease to remain in force. With the lease having been automatically resolved or terminated by agreement of the parties, Ragasa is entitled only to indemnification for damages.

To force either party to continue with a contract that is automatically terminated in case of its breach by either party (pursuant to its express provision) is not in furtherance of or sanctioned by the contract. Rather, it is a contravention thereof and it negates the autonomy characteristic of contracts.

Is the claim of Ragasa that it is entitled to damages in the amount of P3,146,596.42, representing the monthly rentals from July 1, 2001 to January 31, 2003, or the unexpired period of the lease, valid?

Entitlement to rentals after the termination of the lease pursuant to an automatic rescission or termination clause is possible in the case where the lessor invokes the clause and the lessee refuses to vacate the leased premises. The

lessee will be liable for damages equivalent to the rentals for the duration of its possession from the termination of the lease until he vacates the premises. This was in effect the ruling of the Court in Manila Bay Club Corp. when it affirmed the award of the monthly rental equivalent to P 250,000.00, which was the valuation of the trial court as affirmed by the CA, viz.:

Petitioner in its third assignment of error assails the P250,000.00 monthly rental adjudged against it by the trial court and as affirmed by respondent Court of Appeals, claiming that there was no basis for such finding.

Again, we disagree. In reaching that amount, the trial court took into consideration the following factors: 1) prevailing rates in the vicinity; 2) location of the property; 3) use of the property; 4) inflation rate; and 5) the testimony of private respondent Modesta Sabeniano that she was offered by a Japanese-Filipino investor a monthly rental of P400,000.00 for the leased premises then occupied by petitioner.[52] Petitioner for its part should have presented its controverting evidence below to support what it believes to be the fair rental value of the leased building since the burden of proof to show that the rental demanded is unconscionable or exorbitant rests upon the lessee.[53] But petitioner failed to do so. Hence, the valuation by the trial court, as affirmed by respondent Court of Appeals, stands.

It is worth stressing at this juncture that the trial court had the authority to fix the reasonable value for the continued use and occupancy of the leased premises after the termination of the lease contract, and that it was not bound by the stipulated rental in the contract of lease since it is equally settled that upon termination or expiration of the contract of lease, the rental stipulated therein may no longer be the reasonable value for the use and occupation of the premises as a result or by reason of the change or rise in values.[54] Moreover, the trial court can take judicial notice of the general increase in rentals of real estate especially of business establishments[55] like the leased building owned by private respondents.[56]

That is, however, not the situation here. The bank did not continue to possess the Leased Premises after its automatic termination, as it vacated the same on June 30, 2001.

As explained above, the provision or clause that is applicable in case of non-compliance of the Term or period of the Lease Contract is item 8(m) which mandates that the full deposit of P367,821.00 or the equivalent of three months rentals shall be forfeited with the proviso that the deposit cannot be applied to rental. This proviso as to non-application to rental of the deposit means that the forfeiture is without prejudice to the payment of any unpaid rental at the time of the non-compliance or breach of the Term or period of the Lease Contract. Since the bank had no unpaid rental as of June 30, 2001, the proviso finds no application in the present case.

What is the nature of item 8(m) of the Lease Contract: "The full deposit shall be forfeited in favor of the LESSOR upon non-compliance of the Term of the Contract of Lease by the TENANT, and cannot be applied to Rental"?

The Court believes and so holds that item No. 8(m) is a penalty or penal clause.

A penal clause is an accessory obligation which the parties attach to a principal obligation for the purpose of insuring the performance thereof by imposing on the debtor a special prestation (generally consisting in the payment of a sum of money) in case the obligation is not fulfilled or is irregularly or inadequately fulfilled.[57] Quite common in lease contracts, this clause functions to strengthen the coercive force of the obligation and to provide, in effect, for what would be the liquidated damages resulting from a breach.[58]

A penal clause has a three-fold purpose: (1) a coercive purpose or one of guarantee — this is to urge the debtor to the fulfillment of the main obligation under pain of paying the penalty; (2) to serve as liquidated damages — this is to evaluate in advance the damages that may be occasioned by the non-compliance of the obligation; and (3) a strictly penal purpose — this is to punish the debtor for non-fulfillment of the main obligation.[59] While the first purpose is always present, the second purpose is presumed and the third purpose must be expressly agreed

upon.[60]

Stated otherwise, the purposes of penalty or penal clause are: (1) *funcion coercitiva o de garantia* or to insure the performance of the obligation; (2) *funcion liquidatoria* or to liquidate the amount of damages to be awarded to the injured party in case of breach of the principal obligation; and (3) *funcion estrictamente penal* or to punish the obligor in case of breach of the principal obligation, in certain exceptional cases.[61] The second is evidently compensatory and the third is punitive in character, while the first is the general purpose regardless of whether the penalty is compensatory or punitive.[62]

Evidently, the penal clause may be considered either reparation, compensation or substitute for damages, on one hand, or as a punishment in case of breach of the obligation, on the other. When considered as reparation or compensation, the question as to the appropriate amount of damages is resolved once and for all because the stipulated indemnity represents a legitimate estimate made by the contracting parties of the damages caused by the nonfulfillment or breach of the obligation. Proof of actual damages is, consequently, not necessary in order that the stipulated penalty may be demanded. When considered as a punishment, the question of damages is not yet resolved inasmuch as the right to damages, besides the penalty, still subsists. Thus, if the injured party desires to recover the damages actually suffered by him in addition to the penalty, he must prove such damages.[63]

Penal clause may be classified into: (1) according to source: (a) legal (when it is provided by law) and (b) conventional (when it is provided for by stipulation of the parties); (2) according to demandability: (a) subsidiary (when only the penalty may be enforced) and (b) complementary (when both the principal obligation and the penalty may be enforced); and (3) according to purpose: (a) cumulative (when damages may be collected in addition to penalty) and (b) reparatory (when the penalty substitutes indemnity for damages).[64]

Item 8(m) of the Lease Contract is an accessory obligation or prestation to the principal obligation of lease. It specifies the stipulated amount of liquidated damages — the full deposit — to be awarded to the injured party in case of breach of the Term or period of the principal obligation. Hence, as to source, it is conventional.

As defined, liquidated damages are those agreed upon by the parties to a contract, to be paid in case of breach thereof.[65] The amount of the liquidated damages is purely contractual between the parties; and the courts will intervene only to equitably reduce the liquidated damages, whether intended as an indemnity or a penalty, if they are iniquitous or unconscionable, pursuant to Articles 2227 and 1229[66] of the Civil Code.

Also, proof of actual damages suffered by the creditor is not necessary in order that the penalty may be demanded.[67]

Item 8(m) seeks to insure or guarantee the completion of the lease period since its non-compliance shall be met with a penalty. The degree of the coercive effect or impact of the penalty to insure or guarantee the performance of the principal obligation depends largely on the stipulated amount of the liquidated damages. If the amount is substantial, then the compulsion to perform may be greater. The obligor may not, however, be willing to accept a very stiff penalty. As expressed earlier, the amount is purely discretionary on the parties provided that it will pass the test of unconscionability or excessiveness. Since the herein parties have agreed on a specific amount of penalty, P367,821.00 or the full deposit, the Court will not even second guess whether it is substantial enough to insure the compliance of the lease period. The Court will simply rule that it is reasonable.

As to the effect of the penal clause, Article 1226 of the Civil Code provides:

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.

From the first paragraph of Article 1226, it is evident that, as a rule, the penalty is fixed by the contracting parties as a compensation or substitute for damages in case of breach of the obligation; and it is, therefore, clear that the penalty in its compensatory aspect is the general rule, while the penalty in its strictly penal aspect is the exception.[68]

It is also clear from paragraph 1 of Article 1226 that when an obligation or a contract contains a penal clause, the penalty shall substitute the indemnity for damages and the payment of interests in case of noncompliance with or breach of the principal obligation. This general rule, however, admits three exceptions, namely: (1) when there is a stipulation to the contrary; (2) when the obligor or debtor is sued for refusal to pay the agreed penalty; and (3) when the obligor or debtor is guilty of fraud. In these exceptions, it is evident that the purpose of the penalty is to punish since the obligee or creditor can recover from the obligor or debtor not only the penalty, but also the damages or interests resulting from the breach of the principal obligation.[69]

Is item 8(m) intended by the parties for a strictly penal purpose or a punishment on the guilty party? If it is, then item 8(m) is both complementary and cumulative. If it is not, then it is subsidiary and reparatory.

As earlier observed, the third purpose of a penal clause, which is strictly penal, must be expressly agreed upon. This is in consonance with the first sentence of Article 1226 — "the penalty shall substitute the indemnity for damages and interests in case of noncompliance, if there is no stipulation to the contrary." Thus, the contract must expressly provide that in addition to the penalty, the guilty party shall be liable for damages or interests resulting from the breach of the principal obligation.

Item 8(m) does not expressly make a reservation for an additional claim for damages and interests occasioned by the breach of the lease period. There is, however, another provision of the Lease Contract that is triggered by a default in item 8(m), to wit:

10. In the event that a Court Litigation has been resorted to by the LESSOR or LESSEE, due to non-compliance of any of the foregoing provisions, the aggrieved party shall be paid by the other party, no less than fifteen thousand (P15,000) pesos, Philippine Currency, for Attorney's fees, and other damages that the honorable court may allow; the cost of litigations shall be born[e] or paid by the party in fault, or in default. All unpaid accounts and obligations of the TENANT shall earn interest or bear interest at the rate of 14% per annum or at the allowable rate of interest from the date of default. The legal suits shall be brought in the town of Quezon City.[70] (Underscoring supplied)

Being provisions on default, item 8(m) and item 10 must be applied jointly and simultaneously. Thus, aside from the forfeiture of the full deposit, the party at fault or in default is liable, pursuant to item 10 of the Lease Contract, for the payment of attorney's fees in an amount which is not less than P15,000.00, other damages that the court may allow, cost of litigation, and 14% interest per annum on unpaid accounts and obligations.

Can item 10 pass as the "stipulation to the contrary" or the express agreement required in Article 1226? A careful reading of all the pertinent provisions leads the Court to believe that when item 10 provides that "other damages that the court may allow" are recoverable in case of noncompliance of any provision of the Lease Contract, this only means what it says, that the aggrieved party can be awarded damages in addition to the forfeiture of the deposit that is provided in item 8(m). In fine, item 8(m) and item 10, construed together, form a complementary and cumulative penal clause; and it is a punishment or strictly penal.

From the foregoing, the Court accordingly rules that the bank is liable for the forfeiture of the deposit and attorney's fees in the amount of P15,000.00 and such other damages which Ragasa suffered by reason of the breach of the lease period by the bank.

Clearly, the requisites for the demandability of the penal clause are present in this case. These are: (1) that the total non-fulfillment of the obligation or the defective fulfillment is chargeable to the fault of the debtor; and (2) that the penalty may be enforced in accordance with the provisions of law. As to the second requisite, the penalty is demandable when the debtor is in mora in regard to obligations that are positive (to give and to do) where demand may be necessary unless it is excused; and with regard to negative obligations, when an act is done contrary to that which is prohibited.[71]

In the present case, the bank pre-terminated the Lease Contract which is not expressly allowed therein. For not complying with its Term or period, the bank did an act contrary to what is not allowed in the Lease Contract.

Additionally, the bank cannot insist on paying only the penalty. This is proscribed under Article 1227, to wit:

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.

There is nothing in the Lease Contract which provides that the bank can exempt itself from the performance of any provision therein, including the Term or period, by simply paying the penalty. Items 8(m) and 10 do not contain any such exemption.

As discussed above, Ragasa cannot insist on the performance of the lease, i.e., for the lease to continue until expiration of its term, because the lease has been automatically terminated when the bank breached it by pre-terminating its terms. Thus, Ragasa is only entitled to damages.

That said, that is, even as items 8(m) and 10 are considered strictly penal or punishment, Ragasa, as the injured party, is nonetheless required to prove the "other damages" that it actually suffered before it can be entitled thereto. However, a review of the records shows that Ragasa presented nothing. Ragasa simply insisted that the bank should be liable for the amount representing the monthly rentals from July 1, 2001 up to January 31, 2003 or the unexpired term of the Lease Contract, equivalent to P3,146,596.42. Ragasa did not adduce any evidence to support its claim that it actually suffered damages of such amount in terms of lost income. In this regard, it must be emphasized that Ragasa could have leased the Leased Premises as early as July 1, 2001 because the bank had completely vacated the same as of June 30, 2001. That Ragasa chose not to lease the Leased Premises and not earn any rental therefrom in the meantime that its complaint for damages against the bank was being litigated was its own decision and doing.

Article 2203 of the Civil Code provides that "[t]he party suffering loss or injury must exercise the diligence of a good father of a family to minimize the damages resulting from the act or omission." Ragasa likewise failed in this respect.

In conclusion, the Court rules that Ragasa is not entitled to the rental for the unexpired period of the Lease Contract, and it is only entitled to the forfeiture of the full deposit pursuant to item 8(m) and P15,000.00 as attorney's fees pursuant to item 10.

WHEREFORE, premises considered, the instant petition for review is hereby partly GRANTED. The Decision dated March 27, 2009 and the Resolution dated November 25, 2009 of the CA are AFFIRMED WITH MODIFICATION, awarding attorney's fees in the amount of P15,000.00 in favor of petitioner D.M. Ragasa Enterprises, Inc.

SO ORDERED.

Carpio (Chairperson),[*] Peralta, Perlas-Bernabe, and A. Reyes, Jr., JJ., concur.

[*] Senior Associate Justice (Per Section 12, R.A. 296, The Judiciary Act of 1948, as amended)

[1] Rollo, pp. 12-30.

[2] Banco de Oro, Inc., is the surviving corporation upon the merger of Equitable PCI Bank, Inc. and Banco de Oro, Inc., per the Comment of respondent bank, id. at 236-253.

[3] Id. at 33-51. Penned by Associate Justice Pampio A. Abarintos with Associate Justices Amelita G. Tolentino and Ramon R. Garcia concurring.

[4] Id. at 60-62.

[5] Id. at 140-153. Penned by Judge Ofelia Arellano Marquez.

[6] Id. at 154.

[7] Id. at 63-67.

[8] Id. at 63.

[9] Id. at 93.

[10] Id. at 64.

[11] Id. at 63-66.

[12] Id. at 39.

[13] Id.

[14] Id. at 236.

[15] Id. at 237.

[16] Id. at 39.

[17] Id. at 92.

[18] Id. at 93.

[19] Id.

[20] Id. at 134.

[21] Id.

[22] One dated July 27, 2001 and another dated February 27, 2002, id. at 40.

[23] 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)

- [24] Id. at 98.
- [25] Id. at 153.
- [26] Id. at 154.
- [27] Brief for the Defendant-Appellant dated June 20, 2007, id. at 164-166.
- [28] Id. at 50.
- [29] Id. at 60-62.
- [30] Id. at 20-21.
- [31] *Morla v. Belmonte*, 678 Phil. 102, 107 (2011).
- [32] CIVIL CODE, Art. 1159.
- [33] Id. at Art. 1306.
- [34] Id.
- [35] Rollo, pp. 63-66.
- [36] CIVIL CODE, Art. 1370; See *Heirs of Uy Ek Liong v. Castillo*, 710 Phil. 261, 275-276 (2013).
- [37] Rollo, pp. 64-65.
- [38] Id. at 65; underscoring supplied.
- [39] CIVIL CODE, Art. 1659.
- [40] Rollo, p. 65.
- [41] 315 Phil. 805 (1995).
- [42] Id. at 811.
- [43] Id.
- [44] Id. at 826, citing *Pe v. IAC*, 212-A Phil. 94 (1991).
- [45] 516 Phil. 157 (2006).
- [46] 10. SUB-LEASE – The SUBSTITUTE LESSEE cannot sublease the leased premises to any party without first securing the prior written consent of the LESSOR, otherwise the sublease shall not be respected by the latter;
- [47] 13. VIOLATION AND DAMAGES – In case of violation of any terms and conditions contained herein will be a ground for the offended party to terminate the contract even before the end of its term and in case the LESSEE violates the same the LESSOR have the option to terminate the contract without prejudice to his rights to collect whatever rentals due for the remaining years of the contract plus damages.
- [48] 315 Phil. 805, 826 (1995).
- [49] 346 Phil. 189, 202 (1997), citing *Manila Bay Club Corp. v. Court of Appeals*, 315 Phil. 805, 826 (1995); See also *Subic Bay Metropolitan Authority (SBMA) v. Universal International Group of Taiwan (UIG)*, 394 Phil. 691 (2000); *Heirs of San Andres v. Rodriguez*, 388 Phil. 571, 586 (2000).
- [50] *Pangilinan v. Court of Appeals*, 345 Phil. 93 (1997); *Jison v. Court of Appeals*, 247 Phil. 304 (1988).

[51] *Riesenbeck v. Spouses Maceren*, supra note 45 at 170-171.

[52] Citation of the rollo omitted.

[53] Citing *Shoemart v. CA*, 268 Phil. 195, 204-205 (1990).

[54] Citing *Limcay v. Court of Appeals*, 289 Phil. 429, 437 (1992).

[55] Citing *Commander Realty, Inc. v. Court of Appeals*, 250 Phil. 190, 192 (1988).

[56] *Manila Bay Club Corp. v. Court of Appeals, et al.*, supra note 41 at 827-828.

[57] *Pryce Corporation v Philippine Amusement and Gaming Corporation*, 497 Phil. 490, 508 (2005).

[58] *Id.*

[59] EDUARDO P. CAGUIOA, *COMMENTS AND CASES ON CIVIL LAW, CIVIL CODE OF THE PHILIPPINES*, VOL. IV 284 (Rev. Second Ed., 1983).

[60] *Id.*

[61] DESIDERIO P. JURADO, *COMMENTS AND JURISPRUDENCE ON OBLIGATIONS AND CONTRACTS* 207 (Ninth Rev. Ed., 1987), citing 3 Castan, 7[th] Ed., pp. 100-101.

[62] JURADO, supra note 60 at 207.

[63] *Id.* at 208

[64] CAGUIOA, supra note 58 at 279.

[65] CIVIL CODE, Art. 2226.

[66] CIVIL CODE, Art. 1229 provides:

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.

[67] CIVIL CODE, Art. 1228.

[68] JURADO, supra note 60 at 208-209.

[69] JURADO, supra note 60 at 210-211.

[70] Rollo, p. 66.

[71] CAGUIOA, supra note 58 at 280.

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