



Republic of the Philippines  
Supreme Court  
Manila

THIRD DIVISION

ARCO PULP AND PAPER CO., G.R. No. 206806  
INC. and CANDIDA A. SANTOS,

Petitioners,

Present:

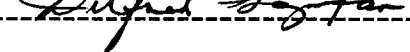
PERALTA, J., *Acting Chairperson*,\*  
VILLARAMA, JR.\*\*  
MENDOZA,  
REYES and\*\*\*  
LEONEN, JJ.

-versus-

DAN T. LIM, doing business under  
the name and style of QUALITY  
PAPERS & PLASTIC PRODUCTS Promulgated:  
ENTERPRISES,

Respondent.

June 25, 2014

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DECISION

LEONEN, J.:

Novation must be stated in clear and unequivocal terms to extinguish an obligation. It cannot be presumed and may be implied only if the old and

\* Associate Justice Diosdado M. Peralta was designated as Acting Chairperson of the Third Division per Special Order No. 1707 dated June 17, 2014, vice Associate Justice Presbitero J. Velasco, Jr., in view of the latter's official trip to Nairobi, Kenya on June 22 to 25, 2014 and to South Africa on June 26 to 29, 2014.

\*\* Associate Justice Martin S. Villarama, Jr. was designated as Acting Member per Special Order No. 1691 dated May 22, 2014, in view of the vacancy in the Third Division.

\*\*\* Associate Justice Bienvenido L. Reyes was designated as Acting Member of the Third Division per Special Order No. 1704 dated June 17, 2014, vice Associate Justice Presbitero J. Velasco, Jr., in view of the latter's official trip to Nairobi, Kenya on June 22 to 25, 2014 and to South Africa on June 26 to 29, 2014.

new contracts are incompatible on every point.

Before us is a petition for review on certiorari<sup>1</sup> assailing the Court of Appeals' decision<sup>2</sup> in CA-GR. CV No. 95709, which stemmed from a complaint<sup>3</sup> filed in the Regional Trial Court of Valenzuela City, Branch 171, for collection of sum of money.

The facts are as follows:

Dan T. Lim works in the business of supplying scrap papers, cartons, and other raw materials, under the name Quality Paper and Plastic Products, Enterprises, to factories engaged in the paper mill business.<sup>4</sup> From February 2007 to March 2007, he delivered scrap papers worth ₱7,220,968.31 to Arco Pulp and Paper Company, Inc. (Arco Pulp and Paper) through its Chief Executive Officer and President, Candida A. Santos.<sup>5</sup> The parties allegedly agreed that Arco Pulp and Paper would either pay Dan T. Lim the value of the raw materials or deliver to him their finished products of equivalent value.<sup>6</sup>

Dan T. Lim alleged that when he delivered the raw materials, Arco Pulp and Paper issued a post-dated check dated April 18, 2007<sup>7</sup> in the amount of ₱1,487,766.68 as partial payment, with the assurance that the check would not bounce.<sup>8</sup> When he deposited the check on April 18, 2007, it was dishonored for being drawn against a closed account.<sup>9</sup>

On the same day, Arco Pulp and Paper and a certain Eric Sy executed a memorandum of agreement<sup>10</sup> where Arco Pulp and Paper bound themselves to deliver their finished products to Megapack Container Corporation, owned by Eric Sy, for his account. According to the memorandum, the raw materials would be supplied by Dan T. Lim, through his company, Quality Paper and Plastic Products. The memorandum of agreement reads as follows:

Per meeting held at ARCO, April 18, 2007, it has been mutually agreed between Mrs. Candida A. Santos and Mr. Eric Sy that ARCO will deliver 600 tons Test Liner 150/175 GSM, full width 76 inches at the price of P18.50 per kg. to Megapack Container for Mr. Eric Sy's account. Schedule of deliveries are as follows:

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<sup>1</sup> *Rollo*, pp. 8–20.

<sup>2</sup> *Id.* at 101–110.

<sup>3</sup> *Id.* at 22–29.

<sup>4</sup> *Id.* at 23, complaint.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 101–102, CA decision.

<sup>7</sup> *Id.* at 38.

<sup>8</sup> *Id.* at 23.

<sup>9</sup> *Id.* at 38.

<sup>10</sup> *Id.* at 39.

....

It has been agreed further that the Local OCC materials to be used for the production of the above Test Liners will be supplied by Quality Paper & Plastic Products Ent., total of 600 Metric Tons at P6.50 per kg. (price subject to change per advance notice). Quantity of Local OCC delivery will be based on the quantity of Test Liner delivered to Megapack Container Corp. based on the above production schedule.<sup>11</sup>

On May 5, 2007, Dan T. Lim sent a letter<sup>12</sup> to Arco Pulp and Paper demanding payment of the amount of ₱7,220,968.31, but no payment was made to him.<sup>13</sup>

Dan T. Lim filed a complaint<sup>14</sup> for collection of sum of money with prayer for attachment with the Regional Trial Court, Branch 171, Valenzuela City, on May 28, 2007. Arco Pulp and Paper filed its answer<sup>15</sup> but failed to have its representatives attend the pre-trial hearing. Hence, the trial court allowed Dan T. Lim to present his evidence ex parte.<sup>16</sup>

On September 19, 2008, the trial court rendered a judgment in favor of Arco Pulp and Paper and dismissed the complaint, holding that when Arco Pulp and Paper and Eric Sy entered into the memorandum of agreement, novation took place, which extinguished Arco Pulp and Paper's obligation to Dan T. Lim.<sup>17</sup>

Dan T. Lim appealed<sup>18</sup> the judgment with the Court of Appeals. According to him, novation did not take place since the memorandum of agreement between Arco Pulp and Paper and Eric Sy was an exclusive and private agreement between them. He argued that if his name was mentioned in the contract, it was only for supplying the parties their required scrap papers, where his conformity through a separate contract was indispensable.<sup>19</sup>

On January 11, 2013, the Court of Appeals<sup>20</sup> rendered a decision<sup>21</sup> reversing and setting aside the judgment dated September 19, 2008 and ordering Arco Pulp and Paper to jointly and severally pay Dan T. Lim the

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<sup>11</sup> Id.

<sup>12</sup> Id. at 40.

<sup>13</sup> Id. at 24.

<sup>14</sup> Id. at 22–29.

<sup>15</sup> Id. at 41–45.

<sup>16</sup> Id. at 52, RTC decision.

<sup>17</sup> Id. at 51–54.

<sup>18</sup> Id. at 71–95.

<sup>19</sup> Id. at 85.

<sup>20</sup> Per Seventeenth Division, penned by J. Villon, and concurred in by J. Macalino and J. Inting.

<sup>21</sup> *Rollo*, pp. 101–110.

amount of ₱7,220,968.31 with interest at 12% per annum from the time of demand; ₱50,000.00 moral damages; ₱50,000.00 exemplary damages; and ₱50,000.00 attorney's fees.<sup>22</sup>

The appellate court ruled that the facts and circumstances in this case clearly showed the existence of an alternative obligation.<sup>23</sup> It also ruled that Dan T. Lim was entitled to damages and attorney's fees due to the bad faith exhibited by Arco Pulp and Paper in not honoring its undertaking.<sup>24</sup>

Its motion for reconsideration<sup>25</sup> having been denied,<sup>26</sup> Arco Pulp and Paper and its President and Chief Executive Officer, Candida A. Santos, bring this petition for review on certiorari.

On one hand, petitioners argue that the execution of the memorandum of agreement constituted a novation of the original obligation since Eric Sy became the new debtor of respondent. They also argue that there is no legal basis to hold petitioner Candida A. Santos personally liable for the transaction that petitioner corporation entered into with respondent. The Court of Appeals, they allege, also erred in awarding moral and exemplary damages and attorney's fees to respondent who did not show proof that he was entitled to damages.<sup>27</sup>

Respondent, on the other hand, argues that the Court of Appeals was correct in ruling that there was no proper novation in this case. He argues that the Court of Appeals was correct in ordering the payment of ₱7,220,968.31 with damages since the debt of petitioners remains unpaid.<sup>28</sup> He also argues that the Court of Appeals was correct in holding petitioners solidarily liable since petitioner Candida A. Santos was "the prime mover for such outstanding corporate liability."<sup>29</sup>

In their reply, petitioners reiterate that novation took place since there was nothing in the memorandum of agreement showing that the obligation was alternative. They also argue that when respondent allowed them to deliver the finished products to Eric Sy, the original obligation was novated.<sup>30</sup>

A rejoinder was submitted by respondent, but it was noted without

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<sup>22</sup> Id. at 110, CA decision.

<sup>23</sup> Id. at 107, CA decision.

<sup>24</sup> Id. at 109, CA decision.

<sup>25</sup> Id. at 111–116.

<sup>26</sup> Id. at 121–122.

<sup>27</sup> Id. at 8–20.

<sup>28</sup> Id. at 126–131.

<sup>29</sup> Id. at 129, comment.

<sup>30</sup> Id. at 133–136.

action in view of A.M. No. 99-2-04-SC dated November 21, 2000.<sup>31</sup>

The issues to be resolved by this court are as follows:

1. Whether the obligation between the parties was extinguished by novation
2. Whether Candida A. Santos was solidarily liable with Arco Pulp and Paper Co., Inc.
3. Whether moral damages, exemplary damages, and attorney's fees can be awarded

The petition is denied.

**The obligation between the parties was an alternative obligation**

The rule on alternative obligations is governed by Article 1199 of the Civil Code, which states:

Article 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.

“In an alternative obligation, there is more than one object, and the fulfillment of one is sufficient, determined by the choice of the debtor who generally has the right of election.”<sup>32</sup> The right of election is extinguished when the party who may exercise that option categorically and unequivocally makes his or her choice known.<sup>33</sup> The choice of the debtor must also be communicated to the creditor who must receive notice of it since:

The object of this notice is to give the creditor . . . opportunity to express his consent, or to impugn the election made by the debtor,

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<sup>31</sup> Entitled *In Re: In Dispensing with Rejoinder*, which states that:

“[U]pon the filing of a Reply (when required), no REJOINDER shall be required by the Court. Instead, the Court shall resolve either to (a) give due course to the petition and either consider the case submitted for decision based on the pleadings or require the parties to submit their respective memoranda; or (b) deny or dismiss the petition, as the case may be.”

<sup>32</sup> Dissenting opinion of Justice Ynares-Santiago in *Chavez v. PEA*, 451 Phil. 1, 102–103 (2003) [Per J. Carpio, En Banc], citing A. M. TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES IV, 203 (1991).

<sup>33</sup> *Borbon II v. Servicewide Specialists*, 328 Phil. 150, 157–158 (1996) [Per J. Vitug, First Division].

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 a competent court.<sup>34</sup>

According to the factual findings of the trial court and the appellate court, the original contract between the parties was for respondent to deliver scrap papers worth ₱7,220,968.31 to petitioner Arco Pulp and Paper. The payment for this delivery became petitioner Arco Pulp and Paper's obligation. By agreement, petitioner Arco Pulp and Paper, as the debtor, had the option to either (1) pay the price or (2) deliver the finished products of equivalent value to respondent.<sup>35</sup>

The appellate court, therefore, correctly identified the obligation between the parties as an alternative obligation, whereby petitioner Arco Pulp and Paper, after receiving the raw materials from respondent, would either pay him the price of the raw materials or, *in the alternative*, deliver to him the finished products of equivalent value.

When petitioner Arco Pulp and Paper tendered a check to respondent in partial payment for the scrap papers, they exercised their option to pay the price. Respondent's receipt of the check and his subsequent act of depositing it constituted his notice of petitioner Arco Pulp and Paper's option to pay.

This choice was also shown by the terms of the memorandum of agreement, which was executed on the same day. The memorandum declared in clear terms that the delivery of petitioner Arco Pulp and Paper's finished products would be to a third person, thereby extinguishing the option to deliver the finished products of equivalent value to respondent.

**The memorandum of agreement did not constitute a novation of the original contract**

The trial court erroneously ruled that the execution of the memorandum of agreement constituted a novation of the contract between the parties. When petitioner Arco Pulp and Paper opted instead to deliver the finished products to a third person, it did not novate the original obligation between the parties.

The rules on novation are outlined in the Civil Code, thus:

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<sup>34</sup> *Ong Guan Can v. Century Insurance Co., Ltd.*, 46 Phil. 592, 594 (1924) [Per J. Villamor, En Banc].  
See also CIVIL CODE, art. 1201.

<sup>35</sup> See *rollo*, p. 53, RTC decision, and *rollo*, p. 108, CA decision.

Article 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)

Article 1292. In order that an obligation may be extinguished by another which substitute 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)

Article 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)

Novation extinguishes an obligation between two parties when there is a substitution of objects or debtors or when there is subrogation of the creditor. It occurs only when the new contract declares so “in unequivocal terms” or that “the old and the new obligations be on every point incompatible with each other.”<sup>36</sup>

Novation was extensively discussed by this court in *Garcia v. Llamas*.<sup>37</sup>

**Novation is a mode of extinguishing an obligation by changing its objects or principal obligations, by substituting a new debtor in place of the old one, or by subrogating a third person to the rights of the creditor.** Article 1293 of the Civil Code defines novation as follows:

“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 rights mentioned in articles 1236 and 1237.”

In general, there are two modes of substituting the person of the debtor: (1) *expromision* and (2) *delegacion*. In *expromision*, the initiative for the change does not come from — and may even be made without the knowledge of — the debtor, since it consists of a third person’s assumption of the obligation. As such, it logically requires the consent of the third person and the creditor. In *delegacion*, the debtor offers, and the creditor accepts, a third person who consents to the substitution and assumes the obligation; thus, the consent of these three persons are necessary. **Both modes of substitution by the debtor require the consent of the creditor.**

Novation may also be extinctive or modificatory. It is extinctive

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<sup>36</sup> CIVIL CODE, art. 1292.

<sup>37</sup> 462 Phil. 779 (2003) [Per. J. Panganiban, First Division].

when an old obligation is terminated by the creation of a new one that takes the place of the former. It is merely modificatory when the old obligation subsists to the extent that it remains compatible with the amendatory agreement. Whether extinctive or modificatory, novation is made either by changing the object or the principal conditions, referred to as objective or real novation; or by substituting the person of the debtor or subrogating a third person to the rights of the creditor, an act known as subjective or personal novation. **For novation to take place, the following requisites must concur:**

- 1) **There must be a previous valid obligation.**
- 2) **The parties concerned must agree to a new contract.**
- 3) **The old contract must be extinguished.**
- 4) **There must be a valid new contract.**

Novation may also be express or implied. It is express when the new obligation declares in unequivocal terms that the old obligation is extinguished. It is implied when the new obligation is incompatible with the old one on every point. **The test of incompatibility is whether the two obligations can stand together, each one with its own independent existence.**<sup>38</sup> (Emphasis supplied)

Because novation requires that it be clear and unequivocal, it is never presumed, thus:

In the civil law setting, *novatio* is literally construed as to make new. **So it is deeply rooted in the Roman Law jurisprudence, the principle — *novatio non praesumitur* — that novation is never presumed.** At bottom, for novation to be a jural reality, its *animus* must be ever present, *debitum pro debito* — basically extinguishing the old obligation for the new one.<sup>39</sup> (Emphasis supplied)

There is nothing in the memorandum of agreement that states that with its execution, the obligation of petitioner Arco Pulp and Paper to respondent would be extinguished. It also does not state that Eric Sy somehow substituted petitioner Arco Pulp and Paper as respondent's debtor. It merely shows that petitioner Arco Pulp and Paper opted to deliver the finished products to a third person instead.

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<sup>38</sup> Id. at 788–790, citing *Idolor v. CA*, 404 Phil. 220, 228 (2001) [Per J. Gonzaga-Reyes, Third Division]; *Agro Conglomerates, Inc. v. CA*, 401 Phil. 644, 655 (2000) [Per J. Quisumbing, Second Division]; *De Cortes v. Venturanza*, 170 Phil. 55, 68 (1977) [Per J. Makasiar, First Division]; *PNB v. Mallari and The First Nat'l. Surety & Assurance Co., Inc.*, 104 Phil. 437, 441 (1958) [Per J. Felix, En Banc]; A. M. TOLENTINO, CIVIL CODE OF THE PHILIPPINES, IV, 390 (1991); *Garcia v. Khu Yek Chiong*, 65 Phil. 466, 468 (1938) [Per C.J. Avanceña, En Banc]; *Babst v. CA*, 403 Phil. 244 (2001) [Per J. Ynares-Santiago, First Division]; *Spouses Bautista v. Pilar Development Corporation*, 371 Phil. 533 (1999) [Per J. Puno, First Division]; *Security Bank and Trust Company, Inc. v. Cuenca*, 396 Phil. 108, 122 (2000) [Per J. Panganiban, Third Division]; *Reyes v. CA*, 332 Phil. 40, 50 (1996) [Per J. Torres, Jr., Second Division]; *Molino v. Security Diners International Corporation*, 415 Phil. 587 (2001) [Per J. Gonzaga-Reyes, Third Division].

<sup>39</sup> *Reyes v. Court of Appeals*, 332 Phil. 40, 56 (1996) [Per J. Torres, Jr., Second Division].



The consent of the creditor must also be secured for the novation to be valid:

**Novation must be expressly consented to.** Moreover, the conflicting intention and acts of the parties underscore the absence of any express disclosure or circumstances with which to deduce a clear and unequivocal intent by the parties to novate the old agreement.<sup>40</sup> (Emphasis supplied)

In this case, respondent was not privy to the memorandum of agreement, thus, his conformity to the contract need not be secured. This is clear from the first line of the memorandum, which states:

Per meeting held at ARCO, April 18, 2007, it has been mutually agreed between Mrs. Candida A. Santos and Mr. Eric Sy. . . .<sup>41</sup>

If the memorandum of agreement was intended to novate the original agreement between the parties, respondent must have first agreed to the substitution of Eric Sy as his new debtor. The memorandum of agreement must also state in clear and unequivocal terms that it has replaced the original obligation of petitioner Arco Pulp and Paper to respondent. Neither of these circumstances is present in this case.

Petitioner Arco Pulp and Paper's act of tendering partial payment to respondent also conflicts with their alleged intent to pass on their obligation to Eric Sy. When respondent sent his letter of demand to petitioner Arco Pulp and Paper, and not to Eric Sy, it showed that the former neither acknowledged nor consented to the latter as his new debtor. These acts, when taken together, clearly show that novation did not take place.

Since there was no novation, petitioner Arco Pulp and Paper's obligation to respondent remains valid and existing. Petitioner Arco Pulp and Paper, therefore, must still pay respondent the full amount of ₱7,220,968.31.

### **Petitioners are liable for damages**

Under Article 2220 of the Civil Code, moral damages may be awarded in case of breach of contract where the breach is due to fraud or bad faith:

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<sup>40</sup> *Land Bank of the Philippines v. Ong*, G.R. No. 190755, November 24, 2010, 636 SCRA 266, 277 [Per J. Velasco, Jr., First Division], citing *Philippine Savings Bank v. Spouses Mañalac*, 496 Phil. 671, 687–688 (2005) [Per J. Ynares-Santiago, First Division].

<sup>41</sup> *Rollo*, p. 39.

Art. 2220. Willfull 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.** (Emphasis supplied)

Moral damages are not awarded as a matter of right but only after the party claiming it proved that the breach was due to fraud or bad faith. As this court stated:

Moral damages are not recoverable simply because a contract has been breached. They are recoverable only if the party from whom it is claimed acted fraudulently or in bad faith or in wanton disregard of his contractual obligations. The breach must be wanton, reckless, malicious or in bad faith, and oppressive or abusive.<sup>42</sup>

Further, the following requisites must be proven for the recovery of moral damages:

An award of moral damages would require certain conditions to be met, to wit: (1) *first*, there must be an injury, whether physical, mental or psychological, clearly sustained by the claimant; (2) *second*, there must be culpable act or omission factually established; (3) *third*, the wrongful act or omission of the defendant is the proximate cause of the injury sustained by the claimant; and (4) *fourth*, the award of damages is predicated on any of the cases stated in Article 2219 of the Civil Code.<sup>43</sup>

Here, the injury suffered by respondent is the loss of ₱7,220,968.31 from his business. This has remained unpaid since 2007. This injury undoubtedly was caused by petitioner Arco Pulp and Paper's act of refusing to pay its obligations.

When the obligation became due and demandable, petitioner Arco Pulp and Paper not only issued an unfunded check but also entered into a contract with a third person in an effort to evade its liability. This proves the third requirement.

As to the fourth requisite, Article 2219 of the Civil Code provides that moral damages may be awarded in the following instances:

Article 2219. Moral damages may be recovered in the following

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<sup>42</sup> *Philippine Savings Bank v. Spouses Castillo*, G.R. No. 193178, May 30, 2011, 649 SCRA 527, 538 [Per J. Nachura, Second Division], citing *Philippine National Bank v. Rocamora*, 616 Phil. 369, 385 (2009) [Per J. Brion, Second Division]; *Pilipinas Shell Petroleum Corporation v. John Bordman Ltd. of Iloilo, Inc.*, 509 Phil. 728, 751 (2005) [Per J. Panganiban, Third Division].

<sup>43</sup> *Francisco v. Ferrer, Jr.*, 405 Phil. 741, 749–750 (2001) [Per J. Pardo, First Division].

and analogous cases:

- (1) A criminal offense resulting in physical injuries;
- (2) Quasi-delicts causing physical injuries;
- (3) Seduction, abduction, rape, or other lascivious acts;
- (4) Adultery or concubinage;
- (5) Illegal or arbitrary detention or arrest;
- (6) Illegal search;
- (7) Libel, slander or any other form of defamation;
- (8) Malicious prosecution;
- (9) Acts mentioned in Article 309;
- (10) Acts and actions referred to in Articles 21, 26, 27, 28, 29, 30, 32, 34, and 35.

Breaches of contract done in bad faith, however, are not specified within this enumeration. When a party breaches a contract, he or she goes against Article 19 of the Civil Code, which states:

Article 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.

Persons who have the right to enter into contractual relations must exercise that right with honesty and good faith. Failure to do so results in an abuse of that right, which may become the basis of an action for damages. Article 19, however, cannot be its sole basis:

Article 19 is the general rule which governs the conduct of human relations. By itself, it is not the basis of an actionable tort. Article 19 describes the degree of care required so that an actionable tort may arise when it is alleged together with Article 20 or Article 21.<sup>44</sup>

Article 20 and 21 of the Civil Code are as follows:

Article 20. Every person who, contrary to law, wilfully or negligently causes damage to another, shall indemnify the latter for the same.

Article 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.

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<sup>44</sup> Concurring opinion of J. Leonen, *Alano v. Logmao*, G.R. No. 175540, April 7, 2014 < [http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2014/april2014/175540\\_leonen.pdf](http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2014/april2014/175540_leonen.pdf) > [Per J. Peralta, Third Division].

To be actionable, Article 20 requires a violation of law, while Article 21 only concerns with lawful acts that are contrary to morals, good customs, and public policy:

Article 20 concerns violations of existing law as basis for an injury. It allows recovery should the act have been willful or negligent. Willful may refer to the intention to do the act and the desire to achieve the outcome which is considered by the plaintiff in tort action as injurious. Negligence may refer to a situation where the act was consciously done but without intending the result which the plaintiff considers as injurious.

Article 21, on the other hand, concerns injuries that may be caused by acts which are not necessarily proscribed by law. This article requires that the act be willful, that is, that there was an intention to do the act and a desire to achieve the outcome. In cases under Article 21, the legal issues revolve around whether such outcome should be considered a legal injury on the part of the plaintiff or whether the commission of the act was done in violation of the standards of care required in Article 19.<sup>45</sup>

When parties act in bad faith and do not faithfully comply with their obligations under contract, they run the risk of violating Article 1159 of the Civil Code:

Article 1159. Obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith.

Article 2219, therefore, is not an exhaustive list of the instances where moral damages may be recovered since it only specifies, among others, Article 21. When a party reneges on his or her obligations arising from contracts in bad faith, the act is not only contrary to morals, good customs, and public policy; it is also a violation of Article 1159. Breaches of contract become the basis of moral damages, not only under Article 2220, but also under Articles 19 and 20 in relation to Article 1159.

Moral damages, however, are not recoverable on the mere breach of the contract. Article 2220 requires that the breach be done fraudulently or in bad faith. In *Adriano v. Lasala*.<sup>46</sup>

To recover moral damages in an action for breach of contract, the breach must be palpably wanton, reckless and malicious, in bad faith, oppressive, or abusive. Hence, the person claiming bad faith must prove its existence by clear and convincing evidence for the law always presumes good faith.

<sup>45</sup> Id.

<sup>46</sup> G.R. No. 197842, October 9, 2013 <  
<http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2013/october2013/197842.pdf>>  
 [Per J. Mendoza, Third Division].

**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 known duty through some motive or interest or ill will that partakes of the nature of fraud. It is, therefore, a question of intention, which can be inferred from one's conduct and/or contemporaneous statements.<sup>47</sup> (Emphasis supplied)**

Since a finding of bad faith is generally premised on the *intent of the doer*, it requires an examination of the circumstances in each case.

When petitioner Arco Pulp and Paper issued a check in partial payment of its obligation to respondent, it was presumably with the knowledge that it was being drawn against a closed account. Worse, it attempted to shift their obligations to a third person without the consent of respondent.

Petitioner Arco Pulp and Paper's actions clearly show "a dishonest purpose or some moral obliquity and conscious doing of a wrong, a breach of known duty through some motive or interest or ill will that partakes of the nature of fraud."<sup>48</sup> Moral damages may, therefore, be awarded.

Exemplary damages may also be awarded. Under the Civil Code, exemplary damages are due in the following circumstances:

Article 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.

Article 2233. Exemplary damages cannot be recovered as a matter of right; the court will decide whether or not they should be adjudicated.

Article 2234. While the amount of the exemplary damages need not be proven, the plaintiff 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.

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<sup>47</sup> *Id.*, citing *Erlinda Francisco v. Ferrer, Jr.*, 405 Phil. 741, 745 (2001) [Per J. Pardo, First Division]; *Magat v. Court of Appeals*, 392 Phil. 63, 76 (2000) [Per J. Pardo, First Division]; *Far East Bank & Trust Company v. Court of Appeals*, 311 Phil. 783, 787 (1995) [Per J. Vitug, En Banc]; *Ace Haulers Corporation v. Court of Appeals*, 393 Phil. 220, 230 (2000) [Per J. Pardo, First Division]; *Tan v. Northwest Airlines, Inc.*, 383 Phil. 1026, 1032 (2000) [Per J. Pardo, First Division]; *Ford Philippines, Inc. v. Court of Appeals*, 335 Phil. 1, 9 (1997) [Per J. Francisco, Third Division]; and *Llorente, Jr. v. Sandiganbayan*, 350 Phil. 820, 843 (1998) [Per J. Panganiban, First Division].

<sup>48</sup> *Adriano v. Lasala*, G.R. No. 197842, October 9, 2013 <<http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2013/october2013/197842.pdf>> [Per J. Mendoza, Third Division].

In *Tankeh v. Development Bank of the Philippines*,<sup>49</sup> we stated that:

**The purpose of exemplary damages is to serve as a deterrent to future and subsequent parties from the commission of a similar offense.** The case of *People v. Rante* citing *People v. Dalisay* held that:

**Also known as ‘punitive’ or ‘vindictive’ damages, exemplary or corrective damages are intended to serve as a deterrent to serious wrong doings, and as a vindication of undue sufferings and wanton invasion of the rights of an injured or a punishment for those guilty of outrageous conduct.** These terms are generally, but not always, used interchangeably. In common law, there is preference in the use of exemplary damages when the award is to account for injury to feelings and for the sense of indignity and humiliation suffered by a person as a result of an injury that has been maliciously and wantonly inflicted, the theory being that there should be compensation for the hurt caused by the highly reprehensible conduct of the defendant—associated with such circumstances as willfulness, wantonness, malice, gross negligence or recklessness, oppression, insult or fraud or gross fraud—that intensifies the injury. The terms punitive or vindictive damages are often used to refer to those species of damages that may be awarded against a person to punish him for his outrageous conduct. In either case, these damages are intended in good measure to deter the wrongdoer and others like him from similar conduct in the future.<sup>50</sup> (Emphasis supplied; citations omitted)

The requisites for the award of exemplary damages are as follows:

- (1) they may be imposed by way of example in addition to compensatory damages, and only after the claimant's right to them has been established;
- (2) that they cannot be recovered as a matter of right, their determination depending upon the amount of compensatory damages that may be awarded to the claimant; and
- (3) the act must be accompanied by bad faith or done in a wanton, fraudulent, oppressive or malevolent manner.<sup>51</sup>

Business owners must always be forthright in their dealings. They cannot be allowed to renege on their obligations, considering that these

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<sup>49</sup> G.R. No. 171428, November 11, 2013 <  
<http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2013/november2013/171428.pdf>>  
[Per J. Leonen, Third Division].

<sup>50</sup> Id.

<sup>51</sup> *Francisco v. Ferrer, Jr.*, 405 Phil. 741, 750 (2001) [Per J. Pardo, First Division], citing *National Steel Corporation v. Regional Trial Court of Lanao del Norte, Br. 2, Iligan City*, 364 Phil. 240, 257–258 (1999) [Per J. Purisima, Third Division].

obligations were freely entered into by them. Exemplary damages may also be awarded in this case to serve as a deterrent to those who use fraudulent means to evade their liabilities.

Since the award of exemplary damages is proper, attorney's fees and cost of the suit may also be recovered. Article 2208 of the Civil Code states:

Article 2208. In the absence of stipulation, attorney's fees and expenses of litigation, other than judicial costs, cannot be recovered, except:

(1) When exemplary damages are awarded[.]

**Petitioner Candida A. Santos  
is solidarily liable with  
petitioner corporation**

Petitioners argue that the finding of solidary liability was erroneous since no evidence was adduced to prove that the transaction was also a personal undertaking of petitioner Santos. We disagree.

In *Heirs of Fe Tan Uy v. International Exchange Bank*,<sup>52</sup> we stated that:

Basic is the rule in corporation law that a corporation is a juridical entity which is vested with a legal personality separate and distinct from those acting for and in its behalf and, in general, from the people comprising it. Following this principle, obligations incurred by the corporation, acting through its directors, officers and employees, are its sole liabilities. **A director, officer or employee of a corporation is generally not held personally liable for obligations incurred by the corporation.** Nevertheless, this legal fiction may be disregarded if it is used as a means to perpetrate fraud or an illegal act, or as a vehicle for the evasion of an existing obligation, the circumvention of statutes, or to confuse legitimate issues.

....

**Before a director or officer of a corporation can be held personally liable for corporate obligations, however, the following requisites must concur: (1) the complainant must allege in the complaint that the director or officer assented to patently unlawful acts of the corporation, or that the officer was guilty of gross negligence or bad faith; and (2) the complainant must clearly and convincingly prove such unlawful acts, negligence or bad faith.**

While it is true that the determination of the existence of any of the

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<sup>52</sup> G.R. No. 166282–83, February 13, 2013, 690 SCRA 519 [Per J. Mendoza, Third Division].

circumstances that would warrant the piercing of the veil of corporate fiction is a question of fact which cannot be the subject of a petition for review on certiorari under Rule 45, this Court can take cognizance of factual issues if the findings of the lower court are not supported by the evidence on record or are based on a misapprehension of facts.<sup>53</sup> (Emphasis supplied)

As a general rule, directors, officers, or employees of a corporation cannot be held personally liable for obligations incurred by the corporation. However, this veil of corporate fiction may be pierced if complainant is able to prove, as in this case, that (1) the officer is guilty of negligence or bad faith, and (2) such negligence or bad faith was clearly and convincingly proven.

Here, petitioner Santos entered into a contract with respondent in her capacity as the President and Chief Executive Officer of Arco Pulp and Paper. She also issued the check in partial payment of petitioner corporation's obligations to respondent on behalf of petitioner Arco Pulp and Paper. This is clear on the face of the check bearing the account name, "Arco Pulp & Paper, Co., Inc."<sup>54</sup> Any obligation arising from these acts would not, ordinarily, be petitioner Santos' personal undertaking for which she would be solidarily liable with petitioner Arco Pulp and Paper.

We find, however, that the corporate veil must be pierced. In *Livesey v. Binswanger Philippines*:<sup>55</sup>

Piercing the veil of corporate fiction is an equitable doctrine developed to address situations where the separate corporate personality of a corporation is abused or used for wrongful purposes. **Under the doctrine, the corporate existence may be disregarded where the entity is formed or used for non-legitimate purposes, such as to evade a just and due obligation, or to justify a wrong, to shield or perpetrate fraud or to carry out similar or inequitable considerations, other unjustifiable aims or intentions, in which case, the fiction will be disregarded and the individuals composing it and the two corporations will be treated as identical.**<sup>56</sup> (Emphasis supplied)

<sup>53</sup> Id. at 525–527, citing *Garcia v. Social Security Commission Legal and Collection*, 565 Phil. 193, 209–210 (2007) [Per Chico-Nazario, Third Division]; *Aratea v. Suico*, 547 Phil. 407, 414 (2007) [Per J. Garcia, First Division]; *Prudential Bank v. Alviar*, 502 Phil. 595 (2005) [Per J. Tinga, Second Division]; *Francisco v. Mallen, Jr.*, G.R. No. 173169, September 22, 2010, 631 SCRA 118, 123 [Per J. Carpio, Second Division]; *Sarona v. National Labor Relations Commission*, G.R. No. 185280, January 18, 2012, 663 SCRA 394, 415 [Per J. Reyes, Second Division].

<sup>54</sup> *Rollo*, p. 38.

<sup>55</sup> G.R. No. 177493, March 19, 2014 <<http://sc.judiciary.gov.ph/pdf/web/viewer.html?file=/jurisprudence/2014/march2014/177493.pdf>> [Per J. Brion, Second Division].

<sup>56</sup> Id., citing J. C. VITUG (Retired Supreme Court Associate Justice), COMMERCIAL LAW AND JURISPRUDENCE, II, 9 (2006); *Lim v. Court of Appeals*, 380 Phil. 60, 76 (2000) [Per J. Buena, Second Division]; *Philippine National Bank v. Ritratto Group, Inc.*, 414 Phil. 494, 505 (2001) [Per J. Kapunan, First Division]; *National Federation of Labor Union (NAFLU) v. Ople*, 227 Phil. 113 (1986) [Per J. Gutierrez, Jr., Second Division]; *Commissioner of Internal Revenue v. Norton & Harrison Company*, 120 Phil. 684 (1964) [Per J. Paredes, En Banc].



According to the Court of Appeals, petitioner Santos was solidarily liable with petitioner Arco Pulp and Paper, stating that:

In the present case, We find bad faith on the part of the [petitioners] when they unjustifiably refused to honor their undertaking in favor of the [respondent]. After the check in the amount of ₱1,487,766.68 issued by [petitioner] Santos was dishonored for being drawn against a closed account, [petitioner] corporation denied any privity with [respondent]. These acts prompted the [respondent] to avail of the remedies provided by law in order to protect his rights.<sup>57</sup>

We agree with the Court of Appeals. Petitioner Santos cannot be allowed to hide behind the corporate veil. When petitioner Arco Pulp and Paper's obligation to respondent became due and demandable, she not only issued an unfunded check but also contracted with a third party in an effort to shift petitioner Arco Pulp and Paper's liability. She unjustifiably refused to honor petitioner corporation's obligations to respondent. These acts clearly amount to bad faith. In this instance, the corporate veil may be pierced, and petitioner Santos may be held solidarily liable with petitioner Arco Pulp and Paper.

**The rate of interest due on the obligation must be reduced in view of *Nacar v. Gallery Frames*<sup>58</sup>**

In view, however, of the promulgation by this court of the decision dated August 13, 2013 in *Nacar v. Gallery Frames*,<sup>59</sup> the rate of interest due on the obligation must be modified from 12% per annum to 6% per annum from the time of demand.

*Nacar* effectively amended the guidelines stated in *Eastern Shipping v. Court of Appeals*,<sup>60</sup> and we have laid down the following guidelines with regard to the rate of legal interest:

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<sup>57</sup> *Rollo*, p. 109.

<sup>58</sup> G.R. No. 189871, August 13, 2013, 703 SCRA 439 [Per J. Peralta, En Banc].

<sup>59</sup> *Id.*

<sup>60</sup> G.R. No. 97412, July 12, 1994, 234 SCRA 78 [Per J. Vitug, En Banc]. The guidelines previously stated that:

I. When an obligation, regardless of its source, *i.e.*, law, contracts, quasi-contracts, delicts or quasi-delicts is breached, the contravenor can be held liable for damages. The provisions under Title XVIII on "Damages" of the Civil Code govern in determining the measure of recoverable damages.

II. With regard particularly to an award of interest in the concept of actual and compensatory damages, the rate of interest, as well as the accrual thereof, is imposed, as follows:

**To recapitulate and for future guidance, the guidelines laid down in the case of *Eastern Shipping Lines* are accordingly modified to embody BSP-MB Circular No. 799, as follows:**

I. When an obligation, regardless of its source, *i.e.*, law, contracts, quasi-contracts, delicts or quasi-delicts is breached, the contravenor can be held liable for damages. The provisions under Title XVIII on “Damages” of the Civil Code govern in determining the measure of recoverable damages.

II. With regard particularly to an award of interest in the concept of actual and compensatory damages, the rate of interest, as well as the accrual thereof, is imposed, as follows:

1. **When the obligation is breached, and it consists in the payment of a sum of money, *i.e.*, a loan or forbearance of money, the interest due should be that which may have been stipulated in writing.** Furthermore, the interest due shall itself earn legal interest from the time it is judicially demanded. **In the absence of stipulation, the rate of interest shall be 6% *per annum* to be computed from default, *i.e.*, from judicial or extrajudicial demand under and subject to the provisions of Article 1169 of the Civil Code.**

2. When an obligation, not constituting a loan or forbearance of money, is breached, an interest on the amount of damages awarded may be imposed at the *discretion of the court* at the rate of 6% *per annum*. No interest, however, shall be adjudged on unliquidated claims or damages, except when or until the demand can be established with reasonable certainty. Accordingly, where the demand is established with reasonable certainty, the interest shall begin to run from the time the claim is made judicially or extrajudicially (Art. 1169, Civil Code), but when such certainty cannot be so reasonably established at the time the demand is made, the interest shall begin to run only from the date the judgment of the court is made (at which time the quantification of damages may be

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1. When the obligation is breached, and it consists in the payment of a sum of money, *i.e.*, a loan or forbearance of money, the interest due should be that which may have been stipulated in writing. Furthermore, the interest due shall itself earn legal interest from the time it is judicially demanded. In the absence of stipulation, the rate of interest shall be 12% *per annum* to be computed from default, *i.e.*, from judicial or extrajudicial demand under and subject to the provisions of Article 1169 of the Civil Code.

2. When an obligation, not constituting a loan or forbearance of money, is breached, an interest on the amount of damages awarded may be imposed at the *discretion of the court* at the rate of 6% *per annum*. No interest, however, shall be adjudged on unliquidated claims or damages except when or until the demand can be established with reasonable certainty. Accordingly, where the demand is established with reasonable certainty, the interest shall begin to run from the time the claim is made judicially or extrajudicially (Art. 1169, Civil Code) but when such certainty cannot be so reasonably established at the time the demand is made, the interest shall begin to run only from the date the judgment of the court is made (at which time the quantification of damages may be deemed to have been reasonably ascertained). The actual base for the computation of legal interest shall, in any case, be on the amount finally adjudged.

3. When the judgment of the court awarding a sum of money becomes final and executory, the rate of legal interest, whether the case falls under paragraph 1 or paragraph 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.

deemed to have been reasonably ascertained). The actual base for the computation of legal interest shall, in any case, be on the amount finally adjudged.

3. When the judgment of the court awarding a sum of money becomes final and executory, the rate of legal interest, whether the case falls under paragraph 1 or paragraph 2, above, shall be 6% *per annum* from such finality until its satisfaction, this interim period being deemed to be by then an equivalent to a forbearance of credit.

And, in addition to the above, judgments that have become final and executory prior to July 1, 2013, shall not be disturbed and shall continue to be implemented applying the rate of interest fixed therein.<sup>61</sup> (Emphasis supplied; citations omitted.)

According to these guidelines, the interest due on the obligation of ₱7,220,968.31 should now be at 6% per annum, computed from May 5, 2007, when respondent sent his letter of demand to petitioners. This interest shall continue to be due from the finality of this decision until its full satisfaction.


**WHEREFORE**, the petition is **DENIED** in part. The decision in CA-G.R. CV No. 95709 is **AFFIRMED**.

Petitioners Arco Pulp & Paper Co., Inc. and Candida A. Santos are hereby ordered solidarily to pay respondent Dan T. Lim the amount of ₱7,220,968.31 with interest of 6% per annum at the time of demand until finality of judgment and its full satisfaction, with moral damages in the amount of ₱50,000.00, exemplary damages in the amount of ₱50,000.00, and attorney's fees in the amount of ₱50,000.00.

**SO ORDERED.**

  
**MARVIC MARIO VICTOR F. LEONEN**  
Associate Justice

WE CONCUR:

  
**DIOSDADO M. PERALTA**  
Associate Justice  
Acting Chairperson

<sup>61</sup> *Nacar v. Gallery Frames*, G.R. No. 189871, August 13, 2013, 703 SCRA 439, 457–458 [Per J. Peralta, En Banc].



**MARTIN S. VILLARAMA, JR.**  
Associate Justice



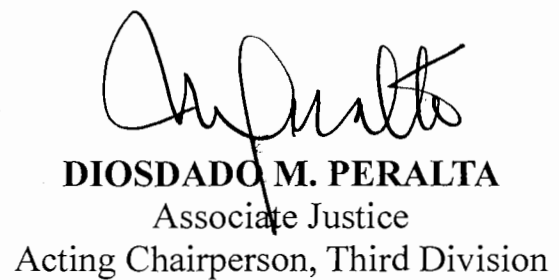
**JOSE CATRAL MENDOZA**  
Associate Justice



**BIENVENIDO L. REYES**  
Associate Justice

### ATTESTATION

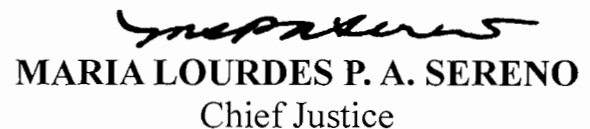
I attest that the conclusions in the above Decision had been reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.



**DIOSDADO M. PERALTA**  
Associate Justice  
Acting Chairperson, Third Division

### CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution and the Division Acting Chairperson's Attestation, I certify that the conclusions in the above Decision had been reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.



**MARIA LOURDES P. A. SERENO**  
Chief Justice