EN BANC

G.R. No. 225433 – LARA'S GIFTS & DECORS, INC., *petitioner*, v. MIDTOWN INDUSTRIAL SALES, INC., *respondent.*

Promulgated:

August 28, 2019

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CONCURRING AND DISSENTING OPINION

LEONEN, *J.*:

I concur with the *ponencia* that the 24% stipulated interest should apply to the unpaid principal obligation of respondent Midtown Industrial Sales, Inc. Such is in accordance with Article 1308 of the Civil Code and jurisprudential pronouncements on the binding force of contracts—not otherwise contrary to law, morals, good customs, or public policy—between contracting parties.

However, I dissent from the application of an interest rate of 12%/6% on the 24% interest, as reckoned from the date of judicial demand until full payment. Compounding the interest at 12%/6% would effectively increase the applicable interest on respondent's unpaid account to more than 24%, making it unconscionable.

Article 2212[1] of the Civil Code should also be subject to the basic doctrine on unconscionable interest rates, where interest on interest should not apply when the stipulated interest rate already borders on being unconscionable. It is high time that this Court made clear: (1) the functions of interest as forbearance of money and as punitive; (2) that unconscionability is a matter of law and equity, and, therefore, should apply to both concepts; and (3) the concept of what unconscionable is.

I

Interest is part of one's payment to the owner for the use of his or her money. It functions as a replacement for the opportunity lost by the owner in profiting from his or her money, which could have been used in a remunerative

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[1] CIVIL CODE, art. 2212 provides:

ARTICLE 2212. Interest due shall earn legal interest from the time it is judicially demanded, although the obligation may be silent upon this point.

investment. In this case, interest is the forbearance of money and is called monetary or conventional interest.[2]

Interest is not a necessary consequence of the use of money. Moreover, it is always agreed upon by the parties.[3] Thus, monetary interest can only be claimed if the parties have expressly stipulated in a written agreement that interest will be paid. This is in accordance with Article 1956 of the Civil Code.[4]

In *Spouses Juico v. China Banking Corporation*,[5] this Court held that the binding effect of contracts is premised on mutuality between parties:

> The binding effect of any agreement between parties to a contract is premised on two settled principles: (1) that any obligation arising from contract has the force of law between the parties; and (2) that there must be mutuality between the parties based on their essential equality. Any contract which appears to be heavily weighed in favor of one of the parties so as to lead to an unconscionable result is void. Any stipulation regarding the validity or compliance of the contract which is left solely to the will of one of the parties, is likewise, invalid.[6]

In *Vitug v. Abuda*,[7] this Court acknowledged that parties are free to set the interest rate in their loan contract, considering the suspension of the Usury Law.[8] *Nonetheless, we emphasized that the validity of the interest rate stipulated is granted under the assumption that: (1) there is parity between the parties; and (2) the interest rate is not unconscionable.* We held:

> The freedom to stipulate interest rates is granted under the assumption that we have a perfectly competitive market for loans where a borrower has many options from whom to borrow. It assumes that parties are on equal footing during bargaining and that neither of the parties has a relatively greater bargaining power to command a higher or lower interest rate. It assumes that the parties are equally in control of the interest rate and equally have options to accept or deny the other party's proposals. In other words, the freedom is granted based on the premise that parties arrive at interest rates that they are willing but are not compelled to take either by force of another person or by force of circumstances.

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[2] *See Isla v. Estorga*, G.R. No. 233974, July 2, 2018, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/64438> [Per J. Perlas-Bernabe, Second Division].

[3] *Siga-an v. Villanueva*, 596 Phil. 760, 769 (2009) [Per J. Chico-Nazario, Third Division].

[4] CIVIL CODE, art. 1956 provides:

ARTICLE 1956. No interest shall be due unless it has been expressly stipulated in writing.

[5] 708 Phil. 495 (2013) [Per J. Villarama, Jr., First Division].

[6] Id. at 507 *citing Spouses Almeda v. Court of Appeals*, 326 Phil. 309, 316 (1996) [Per J. Kapunan, First Division].

The principle of mutuality of contracts is stated in CIVIL CODE, art. 1308, which states:

ARTICLE 1308. The contract must bind both contracting parties; its validity or compliance cannot be left to the will of one of them.

[7] 776 Phil. 540 (2016) [Per J. Leonen, Second Division].

[8] Id. at 567.

> However, the premise is not always true. There are imperfections in the loan market. One party may have more bargaining power than the other. A borrower may be in need of funds more than a lender is in need of lending them. In that case, the lender has more commanding power to set the price of borrowing than the borrower has the freedom to negotiate for a lower interest rate.
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> Hence, there are instances when the state must step in to correct market imperfections resulting from unequal bargaining positions of the parties.
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> . . . .
>
> In stipulating interest rates, parties must ensure that the rates are neither iniquitous nor unconscionable. Iniquitous or unconscionable interest rates are illegal and, therefore, void for being against public morals. The lifting of the ceiling on interest rates may not be read as "grant[ing] lenders carte blanche [authority] to raise interest rates to levels which will either enslave their borrowers or lead to a hemorrhaging of their assets."[9] (Citations omitted)

No mutuality of contracts exists when parties are not on an equal footing in negotiating its terms.[10] The interest rate stipulated is, thus, rendered void when it is skewed in favor of one (1) party over the other.

Vitug declared that when stipulated interest rates are later found to be iniquitous or unconscionable, courts have the discretionary power to equitably reduce them, approximating the prevailing market rate "under the circumstances had the parties had equal bargaining power."[11]

II

There is no hard and fast rule in determining whether an interest rate is unconscionable. It "may be iniquitous and unconscionable in one case, [but] may be totally just and equitable in another."[12]

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[9] Id. at 567–569.

[10] *Spouses Limso v. Philippine National Bank,* 779 Phil. 287, 366–367 (2016) [Per J. Leonen, Second Division].

[11] *Vitug v. Abuda*, 776 Phil. 540, 569 (2016) [Per J. Leonen, Second Division].

[12] *Rizal Commercial Banking Corporation v. Court of Appeals,* 352 Phil. 101, 126 (1998) [Per J. Melo, Second Division].

This Court had previously found that the stipulated monthly interest rates of 2.5%,[13] five percent (5%),[14] 5.5%,[15] six percent (6%),[16] and 10%[17] were unconscionable.

However, in *Toledo v. Hyden*,[18] this Court upheld as valid a monthly interest rate of six percent (6%) to seven percent (7%). It noted that in that case, the borrower was not in dire need of money when she obtained a loan, and it was the borrower herself who was guilty of inequitable acts:

> *In this case, there was no urgency of the need for money on the part of Jocelyn, the debtor, which compelled her to enter into said loan transactions. She used the money from the loans to make advance payments for prospective clients of educational plans offered by her employer. In this way, her sales production would increase, thereby entitling her to 50% rebate on her sales. This is the reason why she did not mind the 6% to 7% monthly interest.* Notably too, a business transaction of this nature between Jocelyn and Marilou continued for more than five years. Jocelyn religiously paid the agreed amount of interest until she ordered for stop payment on some of the checks issued to Marilou. *The checks were in fact sufficiently funded when she ordered the stop payment and then filed a case questioning the imposition of a 6% to 7% interest rate for being allegedly iniquitous or unconscionable and, hence, contrary to morals.*
>
> *It was clearly shown that before Jocelyn availed of said loans, she knew fully well that the same carried with it an interest rate of 6% to 7% per month, yet she did not complain. In fact, when she availed of said loans, an advance interest of 6% to 7% was already deducted from the loan amount, yet she never uttered a word of protest.*
>
> After years of benefiting from the proceeds of the loans bearing an interest rate of 6% to 7% per month and paying for the same, Jocelyn cannot now go to court to have the said interest rate annulled on the ground that it is excessive, iniquitous, unconscionable, exorbitant, and absolutely revolting to the conscience of man.[19] (Emphasis supplied, citations omitted)

Thus, whether a stipulated interest rate is conscionable or unconscionable would depend on the parties' contexts and the circumstances in which the interest rate was applied.

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[13] *Spouses Abella v. Spouses Abella*, 763 Phil. 372, 388 (2015) [Per J. Leonen, Second Division].

[14] *Spouses Castro v. Tan*, 620 Phil. 239 (2009) [Per J. Del Castillo, Second Division].

[15] *Medel v. Court of Appeals*, 359 Phil. 820, 829 (1998) [Per J. Pardo, Third Division].

[16] *De La Paz v. L & J Development Company, Inc.*, 742 Phil. 420, 430–432 (2014) [Per J. Del Castillo, Second Division] and *Spouses Solangon v. Salazar*, 412 Phil. 816, 823 (2001) [Per J. Sandoval-Gutierrez, Third Division].

[17] *Isla v. Estorga*, G.R. No. 233974, July 2, 2018, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/64438> [Per J. Perlas-Bernabe, Second Division].

[18] 652 Phil. 70 (2010) [Per J. Del Castillo, First Division].

[19] Id. at 79–80.

In *Spouses Abella v. Spouses Abella*,[20] this Court held:

> In determining whether the rate of interest is unconscionable, the mechanical application of pre-established floors would be wanting. The lowest rates that have previously been considered unconscionable need not be an impenetrable minimum. What is more crucial is a consideration of the parties' contexts. Moreover, interest rates must be appreciated in light of the fundamental nature of interest as compensation to the creditor for money lent to another, which he or she could otherwise have used for his or her own purposes at the time it was lent. It is not the default vehicle for predatory gain. As such, interest need only be reasonable. It ought not be a supine mechanism for the creditor's unjust enrichment at the expense of another.[21]

We then proceeded to set this guiding parameter:

> The legal rate of interest is the presumptive reasonable compensation for borrowed money. While parties are free to deviate from this, any deviation must be reasonable and fair. Any deviation that is far-removed is suspect. *Thus, in cases where stipulated interest is more than twice the prevailing legal rate of interest, it is for the creditor to prove that this rate is required by prevailing market conditions*.[22] (Emphasis supplied)

Thus, the maximum interest rate that will not cross the line of conscionability is "not more than twice the prevailing legal rate of interest." If the stipulated interest exceeds this standard, the creditor must show that the rate is necessary under current market conditions, or that the parties were on an equal footing when they stipulated on the interest rate.[23]

Furthermore, it was clarified that where the monetary interest rate is found to be unconscionable, only the rate is nullified and deemed not written into the contract; the parties' agreement on the payment of interest remains. In such instance, "the legal rate of interest prevailing at the time the agreement was entered into"[24] ***is applied by the courts.***

III

Interest can also function as a form of penalty or indemnity for damages. It may be stipulated by the parties as a consequence of delay, or it

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[20] 763 Phil. 372 (2015) [Per J. Leonen, Second Division].

[21] Id. at 389.

[22] Id.

[23] *Philippine National Bank v. Court of Appeals*, 308 Phil. 18, 24 (1994) [Per J. Puno, Second Division] *citing Philippine National Bank v. Court of Appeals*, 273 Phil. 789 (1991) [Per J. Griño-Aquino, First Division].

[24] *Isla v. Estorga*, G.R. No. 233974, July 2, 2018, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/64438> [Per J. Perlas-Bernabe, Second Division].

may be imposed by the courts for breach of contract. Articles 2209 and 2210 of the Civil Code state:

> ARTICLE 2209. If the obligation consists in the payment of a sum of money, and *the debtor incurs in delay, the indemnity for damages*, there being no stipulation to the contrary, shall be the payment of the interest agreed upon, and in the absence of stipulation, the legal interest, which is six per cent per annum.
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> ARTICLE 2210. Interest may, in the discretion of the court, be allowed upon damages awarded for *breach of contract.* (Emphasis supplied)

Furthermore, under Article 2212, legal interest may be imposed on interest due, starting from the time of judicial demand:

> ARTICLE 2212. *Interest due shall earn legal interest from the time it is judicially demanded,* although the obligation may be silent upon this point. (Emphasis supplied)

"Interest due" under Article 2212 refers to *accrued stipulated or conventional interest.* This was clarified in *Hun Hyung Park v. Eung Won Choi*:[25]

> To be clear, however, Article 2212 of the Civil Code, which provides that "[i]nterest due shall earn legal interest from the time it is judicially demanded, although the obligation may be silent upon this point," does not apply because "interest due" in Article 2212 refers only to *accrued* interest. A look at the counterpart provision of Article 2212 of the new Civil Code, Article 1109 of the old Civil Code, supports this. It provides:
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> > Art. 1109. **Accrued interest** shall draw interest at the legal rate from the time the suit is filed for its recovery, even if the obligation should have been silent on this point.
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> > In commercial transactions the provisions of the Code of Commerce shall govern.
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> > Pawnshops and savings banks shall be governed by their special regulations. . . .
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> In interpreting the above provision of the old Civil Code, the Court in *Zobel v. City of Manila*, ruled that Article 1109 applies only to conventional obligations containing a stipulation on interest. Similarly, Article 2212 of the new Civil Code contemplates, and therefore applies, only when there exists stipulated or conventional interest.[26] (Emphasis in the original, citations omitted)

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[25] G.R. No. 220826, March 27, 2019, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/65094> [Per J. Caguioa, Second Division].

[26] Id.

In all the situations contemplated under Articles 2209, 2210, and 2212 of the Civil Code, interest is no longer imposed for the use of the lender's money. Instead, it takes the form of damages for either delay or breach of contract. Interest here is called compensatory interest.[27]

IV

Compensatory interest, like monetary interest, is also subject to the unconscionability standard. Articles 1229 and 2227 of the Civil Code allow the reduction of penalty charges or damages that are unconscionable:

> ARTICLE 1229. The judge shall equitably reduce the penalty when the principal obligation has been partly or irregularly complied with by the debtor. Even if there has been no performance, the penalty may also be reduced by the courts if it is iniquitous or unconscionable.
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> ARTICLE 2227. Liquidated damages, whether intended as an indemnity or a penalty, shall be equitably reduced if they are iniquitous or unconscionable.[28]

This Court expounded on this in *Ligutan v. Court of Appeals*:[29]

> A penalty clause, expressly recognized by law, is an accessory undertaking to assume greater liability on the part of an obligor in case of breach of an obligation. It functions to strengthen the coercive force of the obligation and to provide, in effect, for what could be the liquidated damages resulting from such a breach. The obligor would then be bound to pay the stipulated indemnity without the necessity of proof on the existence and on the measure of damages caused by the breach. Although a court may not at liberty ignore the freedom of the parties to agree on such terms and conditions as they see fit that contravene neither law nor morals, good customs, public order or public policy, a stipulated penalty, nevertheless, may be equitably reduced by the courts if it is iniquitous or unconscionable or if the principal obligation has been partly or irregularly complied with.
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> The question of whether a penalty is reasonable or iniquitous can be partly subjective and partly objective. Its resolution would depend on such factors as, but not necessarily confined to, the type, extent and purpose of the penalty, the nature of the obligation, the mode of breach and its consequences, the supervening realities, the standing and relationship of the parties, and the like, the application of which, by and large, is addressed to the sound discretion of the court.[30] (Citations omitted)

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[27] *See Isla v. Estorga*, G.R. No. 233974, July 2, 2018, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/64438> [Per J. Perlas-Bernabe, Second Division] and *Siga-an v. Villanueva*, 596 Phil. 760 (2009) [Per J. Chico-Nazario, Third Division].

[28] As to what liquidated damages mean, CIVIL CODE, art. 2226 provides:
ARTICLE 2226. Liquidated damages are those agreed upon by the parties to a contract, to be paid in case of breach thereof.

[29] 427 Phil. 42 (2002) [Per J. Vitug, Third Division].

[30] Id. at 51–52.

In *Ibarra v. Aveyro*,[31] this Court held that if the penalty clause is so unconscionable that its enforcement constitutes "a repugnant spoliation and an iniquitous deprivation of property,"[32] the courts can strike it down for being invalid.

Palmares v. Court of Appeals[33] involved a ₱30,000.00 loan, payable in two (2) months with interest at six percent (6%) per annum that would be compounded every month. The loan also provided a monthly penalty charge of three percent (3%) and attorney's fees equivalent to 25% of the total amount due and unpaid.

There, this Court removed the monthly three percent (3%) penalty charge for being "highly inequitable and unreasonable":[34]

> In a case previously decided by this Court which likewise involved private respondent M.B. Lending Corporation, and which is substantially on all fours with the one at bar, we decided to eliminate altogether the penalty interest for being excessive and unwarranted under the following rationalization:
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> > Upon the matter of penalty interest, we agree with the Court of Appeals that the economic impact of the penalty interest of three percent (3%) per month on total amount due but unpaid should be equitably reduced. *The purpose for which the penalty interest is intended — that is, to punish the obligor — will have been sufficiently served by the effects of compounded interest.* Under the exceptional circumstances in the case at bar, e.g., the original amount loaned was only P15,000.00; partial payment of P8,600.00 was made on due date; and the heavy (albeit still lawful) regular compensatory interest, the penalty interest stipulated in the parties' promissory note is iniquitous and unconscionable and may be equitably reduced further by eliminating such penalty interest altogether.
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> Accordingly, the penalty interest of 3% per month being imposed on petitioner should similarly be eliminated.[35] (Emphasis supplied, citation omitted)

Meanwhile, this Court had previously ruled that compensatory interest fixed at 24% per annum by contracting parties is not excessive and unconscionable.[36]

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[31] 37 Phil. 273 (1917) [Per J. Torres, First Division].
[32] Id. at 282.
[33] 351 Phil. 664 (1998) [Per J. Regalado, Second Division].
[34] Id. at 690.
[35] Id. at 690–691.
[36] *See Asian Construction and Development Corporation v. Cathay Pacific Steel Corporation*, 636 Phil. 127 (2010) [Per J. Del Castillo, First Division].

V

Article 2209, not Article 2212, is the Civil Code provision that applies to this case.

Here, the contract involved is not a loan or forbearance of money, goods, or credit,[37] but a sale of goods on credit. From January to December 2007, petitioner Lara's Gifts & Decors, Inc. purchased from respondent various industrial and construction materials totaling ₱1,263,104.22. The purchases were on a 60-day credit term, with the condition that a 24% interest rate per annum would be charged on *all accounts overdue*.[38] This means that the 24% interest rate per annum would run only upon respondent's failure to pay on the due date.

Thus, the 24% interest rate is a *compensatory interest*, imposed as indemnity for damages caused by the delay in the payment of the raw materials' purchase price, pursuant to Article 2209.

Since "interest on interest" under Article 2212 is imposable only on stipulated or conventional/monetary interest, the 12%/6% interest cannot be imposed on the 24% interest due on overdue accounts. Moreover, since "interest on interest" under Article 2212 is, by nature, also a compensatory interest, to impose it on top of the stipulated 24% *compensatory* interest would be superfluous.

VI

Even if Article 2212 were applicable, allowing, for instance, the imposition of six percent (6%) "interest on interest" would render the totality of interest imposed in this case unconscionable.

Assuming: A = principal obligation
0.24A = interest due and unpaid
0.06 x 0.24A = 0.0144A = interest on interest
1.24A + 0.0144A = **1.2544A**

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[37] *Estores v. Spouses Supangan*, (686 Phil. 86, 96 (2012) [Per J. Del Castillo, First Division]) defined forbearance as an arrangement other than a loan where a person agrees to the temporary use of his money, goods, or credits subject to the fulfilment of certain conditions.

[38] Ponencia, p. 2.

The application of "interest on interest" at the rate of six percent (6%) would ultimately result in an interest rate of 25.44% on respondent's principal obligation, which is already unconscionable. There must be a showing of externalities accompanying the transaction that could provide the ground for such an excessive rate.

Article 2212 falls within Title XVIII, Chapter 2 of the Civil Code, on "Actual or Compensatory Damages." As previously discussed, it is also subject to the courts' discretionary power when its application would lead to an unconscionable result on the debtor's part. The award of "interest on interest" under Article 2212 is penalty or indemnity for delay in the payment of a sum of money. It is not meant to unjustly enrich the creditor at the debtor's expense.

Here, there is no more need to compound the interest at 12%/6%. The 24% stipulated interest rate, which is twice the prevailing market rate, should be more than enough to compensate for respondent's delay.

As a matter of principle, money itself should not beget money. Money is only generally a store of value. It "has value because people are willing to accept it in exchange for goods and services and in payment for debts."[39]

Allowing money to produce more money—for instance, lending money at excessive interest rates as a way of increasing money—lays the foundation for a growing wealth disparity, since loans are usually extended by those who are richer (with capital) to those who are poorer (without capital). This does not serve the demands of social justice; that is, "the humanization of laws and the equalization of social and economic forces by the State so that justice in its rational and objectively secular conception may at least be approximated."[40]

Money should be put to productive use so that the owner, the society, and the less privileged may all share in the benefits to be derived from it. Passive income "adds no new good or service into the market that would be of use to real persons. Instead, it has the tendency to alter the price of real goods and services to the detriment of those who manufacture, labor, and consume products."[41] The practice of making money out of money skews the economy in favor of speculation and provides a disincentive for real economies.

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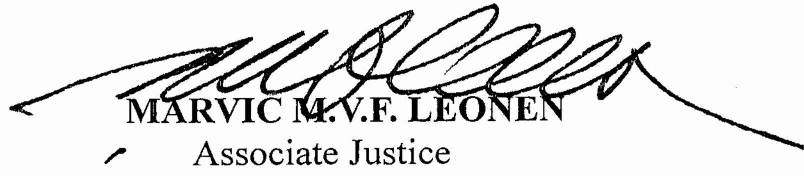
[39] *Palanca v. Court of Appeals*, 308 Phil. 616, 622 (1994) [Per J. Quiason, En Banc].

[40] *Calalang v. Williams*, 70 Phil. 726, 734 (1940) [Per J. Laurel, First Division].

[41] *Cancio v. Performance Foreign Exchange Corporation*, G.R. No. 182307, June 6, 2018, <http://elibrary.judiciary.gov.ph/thebookshelf/showdocs/1/64460> [Per J. Leonen, Third Division].

ACCORDINGLY, I vote to **DENY** the Petition.



MARVIC M.V.F. LEONEN
Associate Justice