

# Without Delay: Reconciling the Divergent Concepts of Substantial Completion and Liquidated Damages in Construction Contracts

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## I. INTRODUCTION

*The construction sector is a critical indicator of the health of an economy. An abundance of stalled construction projects is a visible sign of economic hardship, while a booming construction industry is indicative of economic growth.*

— World Bank<sup>1</sup>

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include *Justice on Trial: Consolidation of Powers, Judicial Independence, and Public Accountability in the Philippine Judiciary*, 63 ATENEO L.J. 21 (2018), co-authored with Sedfrey M. Candelaria; *Finding Maria Clara — The Doctrine and the Filipina*, 63 ATENEO L.J. 317 (2018), co-authored with Amparita D. Sta. Maria; & *In or Out: Gaps in Philippine Immigration Law in Relation to Foreign Athletes and Sports Leagues Regulations as Migration and Human Rights Issues*, 63 ATENEO L.J. 784 (2019), co-authored with Anna Carmi Calsado-Amoroso.

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1. World Bank, *Doing Business 2018: Reforming to Create Jobs (An Annual Report Investigating the Regulation that Enhance Business Activity and those*

The construction industry has witnessed unprecedented growth in the past couple of years.<sup>2</sup> It has “contributed 34.4[%] to overall capital investments or Gross Capital Formation (GFC) in the country” in 2017.<sup>3</sup> In the same year, the construction industry accounted for 8.8% of total employment in the country and U.S.\$66.132 million of the total Foreign Exchange Remittances.<sup>4</sup> Construction output increased by 5.4%, construction investments grew by 5.7%; government infrastructure investments expanded by 13.5%; while private construction activities increased by 3.3%.<sup>5</sup> This growth in the construction industry is due, in part, to the implementation of the current administration’s *Build! Build! Build!* Program<sup>6</sup> and the continuous demand for high-rise residential condominium and commercial buildings.<sup>7</sup>

#### The *Build! Build! Build!* Program

is the Duterte administration’s medium-term goal to increase infrastructure spending from 5.4[%] of the country’s Gross Domestic Product (GDP) in 2017, to 7.3[%] by the end of President Rodrigo Duterte’s term in 2022. This is higher than the 2.4[%] average recorded by the past six administrations in the last five decades — and the highest budget allocation for infrastructure in Philippine history.<sup>8</sup>

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that Constrain it by World Bank) at 25, *available at* <http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf> (last accessed May 5, 2019).

2. See BusinessWorld, *A construction boom and a thriving cement industry*, BUSINESSWORLD, Sep. 26, 2018, *available at* <https://www.bworldonline.com/a-construction-boom-and-a-thriving-cement-industry> (last accessed May 5, 2019) & Rizal Raoul Reyes, *Property boom spreading growth and attracting investors*, BUS. MIRROR, May 1, 2018, *available at* <https://businessmirror.com.ph/2018/05/01/property-boom-spreading-growth-and-attracting-investors> (last accessed May 5, 2019).
3. Construction Industry Authority of the Philippines, 2017 Year End Construction Industry Performance Highlights (A Report by the Department of Trade and Industry) at 1, *available at* <http://ciap.dti.gov.ph/sites/default/files/publications/2017%20Year%20End%20CIPP.pdf> (last accessed May 5, 2019).
4. *Id.*
5. *Id.*
6. BusinessWorld, *supra* note 2 & Reyes, *supra* note 2.
7. See BusinessWorld, *supra* note 2.
8. Anna Mae Yu Lamentillo, *What is ‘Build, Build, Build’?*, MANILA BULL., Mar. 23, 2018, *available at* <https://news.mb.com.ph/2018/03/23/what-is-build-build-build> (last accessed May 5, 2019).

It seeks “to accelerate infrastructure spending and develop industries that will yield robust growth, create jobs[,] and improve the lives of Filipinos.”<sup>9</sup> On the other hand, private construction has steadily grown due to the increasing market demand for residential, commercial, and institutional infrastructure.<sup>10</sup>

The growth in public and private construction has been attributed “to high consumer confidence, modest inflation and interest rates, and improving labor market conditions.”<sup>11</sup> Experts project the boom in the construction industry to carry on for the next several years.<sup>12</sup> The growth in the industry comes with specific challenges that must be addressed if the developments will be sustained — among the more salient issues are delays and labor deficits.<sup>13</sup>

With these developments that have spanned decades to accomplish, the State has become directly and indirectly interested in the construction industry. Thus, as early as 1980, the government created the Construction Industry Authority of the Philippines (CIAP) recognizing

[that] the construction industry constitutes an important segment of the industrial sector and contributes significantly to the gross national product of the Philippines;

[that] construction is now a major industry ... providing livelihood to more than three million Filipinos;

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9. Sara Mae D. Mawis, *Understanding the ‘Build, Build, Build’ program*, PHIL. DAILY INQ., July 28, 2018, available at <https://business.inquirer.net/254682/understanding-build-build-build-program> (last accessed May 5, 2019).
  10. Bernie Cahiles-Magkilat, *DTI: Share of public construction fast catching up with private sector*, MANILA BULL., Nov. 10, 2018, available at <https://business.mb.com.ph/2018/11/10/dti-share-of-public-construction-fast-catching-up-with-private-sector> (last accessed May 5, 2019).
  11. *Id.*
  12. Jeandie O. Galolo, *Construction boom in PH to continue*, SUNSTAR PHIL., Feb. 13, 2017, available at <https://www.sunstar.com.ph/article/125929> (last accessed May 5, 2019).
  13. See The Philippine Star, *Tight labor supply causing construction delays*, PHIL. STAR, Dec. 28, 2016, available at <https://www.philstar.com/business/2016/12/28/1657247/tight-labor-supply-causing-construction-delays> (last accessed May 5, 2019) & Amy R. Remo, *Addressing delays in construction*, PHIL. DAILY INQ., Nov. 4, 2018, available at [https://business.inquirer.net/239943/addressing-delays-construction?utm\\_expnid=.XqNwTug2W6NwDVUSgFJXed.1](https://business.inquirer.net/239943/addressing-delays-construction?utm_expnid=.XqNwTug2W6NwDVUSgFJXed.1) (last accessed May 5, 2019).

[and that] the orderly growth and development of the construction industry and the upgrading of the capability of construction contractors are in consonance with national interest and will benefit both public and private sector[.]<sup>14</sup>

The CIAP's mandate is to “promote, accelerate[,] and regulate the growth and development of the construction industry in conformity with national goals.”<sup>15</sup> The CIAP is vested with the power “[t]o monitor and study the operations of the construction industry both here and abroad, to identify its needs, problems[,] and opportunities[,] and to recommend and/or implement policies, legislations, programs[,] and measures to support the development of the industry;”<sup>16</sup> and “[t]o recommend and encourage the adoption of equitable and realistic contract conditions for construction.”<sup>17</sup>

Pursuant to the powers enumerated, the CIAP Board approved the adoption of the Uniform General Conditions of Contract for Government Construction (CIAP Document 101) and Uniform General Conditions of Contract for Private Construction (CIAP Document 102) “to, among others, embody the conditions or stipulations ordinarily established in construction contracts in the Philippines[.]”<sup>18</sup> The CIAP Board envisioned “the use and [application of] ... the provisions of CIAP Documents 101 and 102, as the case may be, to serve as the procedures, guidelines[,] and criteria to be used by the contracting parties, more specifically in the adjudication and settlement of claims and disputes in contract implementation.”<sup>19</sup>

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14. Creating the Construction Industry Authority of the Philippines (CIAP), Presidential Decree 1746, whereas cl. (1980).

15. *Id.* § 2.

16. *Id.* § 2 (b).

17. *Id.* § 2 (f).

18. Construction Industry Authority of the Philippines, Adopting the Amended PDCB-POCB Joint Board Resolution No. 1, Series of 2004 Re: The Promulgation of a Policy to Bolster the Acceptance and Use of Uniform General Conditions of Contract in Public and Private Construction, CIAP Board Resolution No. 1, whereas cl. (2005).

19. *Id.* CIAP Document 101 provides for “a custom set of conditions [for Public works] ... prepared for the particular branch of government ... and for the local government units.” Robert N. Dio, *Understanding construction contracts*, PHIL. ADR REV., March 2013.

Courts and arbitral tribunals have sometimes relied on CIAP Document 102 in resolving private construction industry disputes.<sup>20</sup> One of the commonly cited provision of CIAP Document 102 is Section 20.11 on Substantial Completion, which reads,

20.11 SUBSTANTIAL COMPLETION AND ITS EFFECT:

- A. [a] There is substantial completion when the Contractor completes ninety-five percent (95%) of the Work, provided that the remaining work and the performance of the work necessary to complete the Work shall not prevent the normal use of the completed portion.

[b] The approval by the Owner of the Contractor's billing for completing at least ninety-five percent (95%) of the Work shall be deemed the Owner's acknowledgment that the Contractor has substantially completed the Work unless the Owner can establish that the unfinished work prevents the normal use of the completed portion.

[c] The Owner may also issue to the Contractor a written acknowledgement of substantial completion which may be in the form of a Certificate of Substantial Completion or equivalent document but the date of this document shall not be controlling if substantial completion is shown to have been made at an earlier date, unless the Contractor accepts the certificate without taking exceptions thereto in writing within fifteen (15) days from receipt.

- B. [a] Notwithstanding paragraph A above, the equipment, fixtures[,] and utilities (collectively, the "Facility") furnished and/or installed by the Contractor which the Contract requires to be test-run prior to acceptance shall be test-run successfully before the Work can be accepted as substantially completed.

[b] The Owner shall, without delay, cause the test-run of the Facility. Should the Contractor be unable to completely install or furnish and test-run the Facility through no fault of his, the Contractor shall automatically be entitled to an extension of Completion Time equal to the period of delay.

- C. [a] The Owner shall issue to the Contractor one or more lists of defects found or discovered on the completed work, otherwise known as a punch list or lists, which the Contractor must receive from the Owner not later than thirty (30) days from date of substantial completion.

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20. See, e.g., Diesel Construction Co., Inc. v. UPSI Property Holdings, Inc., 549 SCRA 12 (2008).

[b] The Owner may add to the punch list items but only as to corrective work on the items in the original punch[ ]list or lists not later than sixty (60) days from date of substantial completion.

- D. [a] No liquidated damages for delay beyond the Completion Time shall accrue after the date of substantial completion of the Work.

[b] If the targeted date of completion has arrived and the Contractor cannot achieve ninety[-]five percent (95%) completion of the Work due to the uncompleted Facility caused by the Owner's fault, negligence[,] or delay of the Owner, the Contractor shall be deemed to have achieved substantial completion provided (i) the contractor has completed at least ninety[-]five percent (95%) of the work minus the uncompleted Facility, and (ii) the Contractor has completed the work required on the Facility but for that which is directly affected by the Owner's fault, negligence[,] or delay. The Owner shall release to the Contractor the Contract Price less the cost of the uncompleted portion of the work and the amounts mentioned in Article 22.03.

- E. The purpose of this [a]rticle is to ensure that the Contractor is paid for Work completed and for the Owner to retain such portion of the Contract Price, which, together with the Performance Bond, is sufficient to complete the Work without additional cost to the Owner.<sup>21</sup>

The Supreme Court has, in some cases, considered the 95% substantial completion threshold set out in Section 20.11 of CIAP Document 102 industry practice, and used the same to justify the exoneration of a party from liability for liquidated damages,<sup>22</sup> regardless of whether the parties have agreed to adopt CIAP Document 102 as their agreement. The Court has held that in cases where the construction contract has been fulfilled up to at least 95% of the total contract price, the contractor, though in delay, will no longer be liable for liquidated damages, there having been substantial performance of the obligation on account of Article 1234 of the Civil Code in relation to Article 1376 of the Civil Code and Section 20.11 of CIAP Document 102.<sup>23</sup>

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21. Construction Industry Authority of the Philippines, Uniform General Conditions of Contract [CIAP Document 102], § 20.11 (2004).

22. *See* Transcept Construction and Management Professionals, Inc. v. Aquilar, 637 SCRA 574 (2010).

23. *Id.* Articles 1232 and 1376 of the Civil Code provide:

Art. 1234. If the obligation has been substantially performed in good faith, the obligor may recover as though there had been a strict and complete fulfillment, less damages suffered by the obligee. (n)

This Article submits that the above characterization of the Court on the matter is problematic and raises a number of issues. For purposes of this Article, the authors limit the analysis to how to reconcile the conflict between a stipulation on liquidated damages and the rule on substantial completion contemplated in certain Supreme Court Decision. The Authors believe that a stipulation in a construction contract on liquidated damages arising from delay without a concomitant stipulation on substantial completion in relation thereto, particularly as provided under CIAP Document 102, should foreclose the application of the doctrine of substantial performance codified as Article 1234 of the Civil Code. The owner may have the provision on liquidated damages enforced irrespective of the fact of substantial performance for the following reasons:

*First*, the freedom of contract must prevail over equity when the stipulation on liquidated damages is neither iniquitous nor unconscionable, there being an implied waiver of the substantial performance provision by the very stipulation on liquidated damages arising from delay.

*Second*, the legal histories of the substantial performance provision and liquidated damages show that substantial performance cannot prevail over a stipulation on liquidated damages arising from delay.

CIAP Document 102 was issued merely as a codification of industry best practices whose provisions the CIAP *recommends* to be incorporated in private construction contracts.<sup>24</sup> These provisions, being contractual undertakings, cannot be read into contracts without the parties' consent. When parties do not incorporate the provisions of CIAP Document 102 into their contract, Section 20.11 on substantial completion may not be invoked as causes of action or defenses in suits for specific performance, rescission, or damages.

It is submitted that in situations when the contract does not provide for substantial completion, the measure of liquidated damages arising from delay shall be that which has been agreed upon by the parties, substantial completion having been waived as a defense against liability by its exclusion from the written contract. CIAP Document 102 cannot supply what has not been agreed upon by the parties, there being an assumption that the parties

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Art. 1376. The usage or custom of the place shall be borne in mind in the interpretation of the ambiguities of a contract, and shall fill the omission of stipulations which are ordinarily established. (1287)

An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, arts. 1234 & 1376 (1950).

24. CIAP Board Resolution No. 1, *supra* note 18.



intended full completion of the project by the fact of stipulating on liquidated damages. Article 1234 on substantial performance affects the right to collect the full contract price — which may be properly anchored on the substantial completion provision in CIAP Document 102 in terms of determining what is substantial completion in the construction industry — but it cannot negate the damages suffered and those agreed upon by the parties.

Thus, an abandonment of the doctrine set forth in the case of *Diesel Construction Co., Inc. v. UPSI Property Holdings, Inc.*,<sup>25</sup> reaffirmed in *Transcept Construction and Management Professionals, Inc. v. Aguilar*<sup>26</sup> and *Werr Corporation International v. Highlands Prime, Inc.*,<sup>27</sup> is necessary to protect construction industry participants from the ever-looming threats of stalling and stagnation. The same is also advocated for the sustenance of growth in the industry founded on investor confidence arising from the risk management features of stipulations on liquidated damages, which is sought here to be upheld, save only for iniquitousness or unconscionability.

## II. CASE LAW ON SUBSTANTIAL COMPLETION AND LIQUIDATED DAMAGES

Contractors facing liability for liquidated damages arising from delay have pleaded substantial completion before courts and arbitral tribunals in order to be relieved therefrom.<sup>28</sup> In these cases, the Court has made doctrinal pronouncements on the appreciation of the substantial completion provision in CIAP Document 102 as it relates to Articles 1234 and 1376 of the Civil Code.

### A. *Diesel Construction Co., Inc. v. UPSI Property Holdings, Inc.*

In *Diesel Construction Co., Inc.*, Diesel Construction Co., Inc. (Diesel) and UPSI Property Holdings, Inc. (UPSI) entered into a Construction Agreement (Agreement) for the interior architectural construction works for

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25. *Diesel Construction Co., Inc. v. UPSI Property Holdings, Inc.*, 549 SCRA 12 (2008).

26. *Transcept Construction and Management Professionals, Inc. v. Aguilar*, 637 SCRA 574 (2010).

27. *Werr Corporation International v. Highlands Prime, Inc.*, 817 SCRA 145 (2017).

28. See, e.g., *Diesel Construction Co., Inc.*, 549 SCRA 12; *Transcept Construction and Management Professionals, Inc.*, 637 SCRA 574; & *Werr Corporation International*, 817 SCRA 145.

the 14th to 16th floors of the UPSI Building.<sup>29</sup> Diesel, as the contractor, agreed to undertake the project for around ₱12 million, payable through progress billings.<sup>30</sup> Diesel posted a performance bond in favor of UPSI.<sup>31</sup> Under the Agreement, the project was to run for a period of 90 days.<sup>32</sup> However, there was a section in their Agreement which obliged the contractor, in case of unjustifiable delay, to pay the owner liquidated damages in the amount of one-fifth of one percent of the total Project cost for each calendar day of delay.<sup>33</sup>

Throughout the implementation of the Project, Diesel requested for extensions of time owing to the following causes of delay: (1) manual hauling of materials from the 14th to 16th floors; (2) delayed supply of marble; (3) various change orders; and (4) delay in the installation of shower assembly.<sup>34</sup> UPSI disapproved these extensions; thus, Diesel defaulted in its obligation.<sup>35</sup> UPSI assessed Diesel for damages.<sup>36</sup>

On 16 March 2000, Diesel sent a notice to UPSI that they had finished the undertaking.<sup>37</sup> However, UPSI disregarded this, withheld Diesel's 10% retention money, and refused to pay the unpaid balance of the contract price.<sup>38</sup> Diesel filed a complaint before the Construction Industry Arbitration Commission (CIAC), praying that UPSI be compelled to pay the unpaid balance of the contract.<sup>39</sup> The CIAC rendered judgment in favor of Diesel, albeit at an amount lesser than what was prayed for.<sup>40</sup> Diesel and UPSI each sought reconsideration.<sup>41</sup> The Court of Appeals (CA) issued its Resolution, denying reconsideration to UPSI, but partially granted Diesel's motion.<sup>42</sup>

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29. *Diesel Construction Co., Inc.*, 549 SCRA at 16.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.* at 17.

34. *Id.*

35. *Diesel Construction Co., Inc.*, 549 SCRA at 17.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 18.

41. *Diesel Construction Co., Inc.*, 549 SCRA at 19.

42. *Id.*

Before the Court, UPSI sought reconsideration arguing that Diesel is not entitled to the release of its retention money and full payment of the contract price because it had abandoned the Project.<sup>43</sup> UPSI likewise argues that Diesel is liable for liquidated damages as provided for in the Agreement for the delay in the Project's completion.<sup>44</sup> The Court, through Justice Presbitero J. Velasco, Jr., found no merit in UPSI's claims, ratiocinating in this wise —

Hence, as correctly held by the CIAC, UPSI, no less, effectively moved the completion date, through the various [Change Orders], to [7 April 2000].

Moreover, as evidenced by UPSI's Progress Report No. 19 for the period ending [22 March 2000], Diesel's scope of work, as of that date, was already 97.56% complete. *Such level of work accomplishment would, by any rational norm, be considered as substantial to warrant full payment of the contract amount, less actual damages suffered by UPSI.* Article 1234 of the Civil Code says as much, 'If the obligation had been substantially performed in good faith, the obligor may recover as though there had been a strict and complete fulfillment, less damages suffered by the obligee.'

The fact that the laborers of Diesel were still at the work site as of [22 March 2000] is a reflection of its honest intention to keep its part of the bargain and complete the Project. Thus, when Diesel attempted to turn over the premises to UPSI, claiming it had completed the Project on [15 March 2000], Diesel could no longer be considered to be in delay. Likewise, the CIAC cited the [CIAP Document 102], wherein it is stated that no liquidated damages for delay beyond the completion time shall accrue after the date of substantial completion of the work.

In all, Diesel cannot be considered as in delay and, hence, is not amenable under the Agreement for liquidated damages.<sup>45</sup>

In finally disposing the case, the Court upheld Diesel's entitlement to payment equal to 97.56% of the works it accomplished and that UPSI may not claim damages arising from delay.<sup>46</sup> Here, the Court looked positively on the CIAC's citation of CIAP Document 102 as basis for Diesel's exoneration from payment of liquidated damages arising from delay.<sup>47</sup>

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43. *Id.* at 20.

44. *Id.*

45. *Id.* at 28-29 (emphasis supplied).

46. *Id.* at 32.

47. *Diesel Construction Co., Inc.*, 549 SCRA at 29.

The citation, however, seems to be an *obiter dictum*, there being no real occasion for the application of the rule on substantial completion.<sup>48</sup> The facts of the case show that as of 22 March 2000, Diesel had already achieved 97.56% completion and that the Project deadline was moved to 7 April 2000.<sup>49</sup> It is unclear whether between the material dates stated above, actual completion took place or could have taken place. In other words, the case turned upon the fact that Diesel was not actually in delay when UPSI filed the case, and thus, not liable for liquidated damages.<sup>50</sup>

*B. Transcept Construction and Management Professionals, Inc. v. Aguilar*

The facts of *Transcept Construction and Management Professionals, Inc.* are as follows — “Teresa C. Aguilar (Aguilar) entered into an Owner-General Contractor Agreement (First Contract) with Transcept Construction and Management Professionals, Inc. (Transcept) for the construction of a two-storey split level vacation house.”<sup>51</sup> The Project cost ₱3,486,878.64 and was to be finished within 210 days from the date of the First Contract.<sup>52</sup> Aguilar was charged with a second billing ahead of the actual accomplishment.<sup>53</sup> She found this unusual, so she did not pay.<sup>54</sup> Transcept, then, ceased to work on the project.<sup>55</sup>

Aguilar hired Engr. Jaime E. Rioflorido from ASTEC Materials Testing Corporation to test Transcept’s quality of work.<sup>56</sup> The results showed that the works done were substandard in materials and workmanship and that Transcept made unreasonable and fraudulent charges in the billing.<sup>57</sup> The engineer recommended the partial demolition of the work.<sup>58</sup>

Transcept and Aguilar entered into a Second Contract to move the date of completion and to use a portion of the down payment made by Aguilar.<sup>59</sup>

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48. *Id.*

49. *Id.* at 28-29.

50. *Id.* at 29.

51. *Transcept Construction and Management Professionals, Inc.*, 637 SCRA at 575.

52. *Id.*

53. *Id.* at 576.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Transcept Construction and Management Professionals, Inc.*, 637 SCRA at 576.

58. *Id.*

59. *Id.*

Transcept still failed to accomplish the Project.<sup>60</sup> It reasoned that the delay was due to the additional works and also demanded extra payment.<sup>61</sup> Aguilar denied that there were additional works.<sup>62</sup>

Aguilar sent a demand letter for the payment of ₱581,844.54 for refund and damages, but this was left unheeded.<sup>63</sup> Aguilar filed a complaint against Transcept before the CIAC.<sup>64</sup> The CIAC ruled that “the accomplishment of ₱1,602,359.97 was 98.16% of ₱1,632,436.29, which was way above 95% and should[,] therefore[,] be considered as substantial completion of the Project.”<sup>65</sup> Hence, Aguilar was not awarded liquidated damages.<sup>66</sup> However, the CIAC awarded Consultancy Expenses to Aguilar as well as additional compensation for the extra works under the Second Contract in favor of Transcept.<sup>67</sup>

On appeal, the court ruled that “Transcept only accomplished 87.81% of the contract price thus entitling Aguilar to liquidated damages equivalent to 10% of ₱1,632,436.29 or ₱163,243.63.”<sup>68</sup> The CA found that Aguilar was able to prove that she is entitled to ₱135,000 for the consultancy services.<sup>69</sup> It also found that there were no additional works as the Second Contract was only to rectify the poorly done works by Transcept.<sup>70</sup> Transcept filed a motion for reconsideration, which was denied.<sup>71</sup>

The question before the Court is whether Aguilar is entitled to liquidated damages. The Court held in the negative, *viz* —

Section 20.11 (A) (a) of the CIAP Document[ ]102 provides that “[t]here is substantial completion when the Contractor completes 95% of the Work, provided that the remaining work and the performance of the work

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60. *Id.*

61. *Id.*

62. *Id.*

63. *Transcept Construction and Management Professionals, Inc.*, 637 SCRA at 576.

64. *Id.*

65. *Id.* at 577.

66. *Id.*

67. *Id.* at 577-78.

68. *Id.* at 579.

69. *Transcept Construction and Management Professionals, Inc.*, 637 SCRA at 579.

70. *Id.*

71. *Id.* at 580.

necessary to complete the Work shall not prevent the normal use of the completed portion.’

According to CIAC’s computation, Transcept’s accomplishment amounted to 98.16% of the contract price. It is beyond the 95% required under CIAP Document[ ]102 and is considered a substantial completion of the Project. We[,] thus[,] agree with CIAC’s application of Article 1234 of the Civil Code, which provides that ‘[i]f the obligation had been substantially performed in good faith, the obligor may recover as though there had been a strict and complete fulfillment, less damages suffered by the obligee.’

There being a substantial completion of the Project, Aguilar is not entitled to liquidated damages but only to actual damages of ₱30,076.72, representing the unaccomplished works in the Second Contract as found by the CIAC, which is the difference between the contract price of ₱1,632,436.29 and the accomplishment of ₱1,602,359.97.<sup>72</sup>

In this case, the Court, in no uncertain terms, adopted Section 20.11 of CIAP Document 102 as a controlling determinant of entitlement to liquidated damages arising from delay in construction contracts. The reasoning behind the adoption is more clearly stated in the case of *Werr Corporation International v. Highlands Prime, Inc.*

*C. Werr Corporation International v. Highlands Prime, Inc.*

In *Werr Corporation International*, Highlands Prime, Inc. (HPI) and Werr Corporation International (Werr) executed a General Building Agreement for the construction of 54 residential units known as “The Horizon-Westridge Project.”<sup>73</sup> Pursuant to the Agreement, Werr was to complete the project within 210 calendar days from receipt of the Notice of Award/Notice to Proceed on 22 July 2005, or until 19 February 2006.<sup>74</sup> HPI undertook to pay Werr a lump sum contract price of ₱271,797,900 subject to the following payment scheme:

- (1) HPI shall pay 20% of the contract price upon the execution of the agreement and the presentation of the necessary bonds and insurance required under the contract, and shall pay the balance on installments progress billing subject to recoupment of down[ ]payment and retention money;
- (2) HPI shall retain 10% of the contract price in the form of retention bond provided by Werr;

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72. *Id.* at 581-82.

73. *Werr Corporation International*, 817 SCRA at 148-49.

74. *Id.* at 149.

- (3) HPI may deduct or set off any sum against monies due Werr, including expenses for the rectification of defects in the construction project; and
- (4) HPI has the right to liquidated damages in the event of delay in the construction of the project equivalent to [one-tenth] of [one percent] of the contract price for every day of delay.<sup>75</sup>

Upon HPI's payment of the stipulated 20% down payment, Werr commenced with the construction project.<sup>76</sup> The project was not completed on the initial completion date, which led HPI to grant several extensions and a final extension.<sup>77</sup> As of the last billing on 25 October 2006, HPI had already paid the amount corresponding to 93.18% accomplishment rate of the project.<sup>78</sup> The project was not completed on the last extension given.<sup>79</sup> Thus, HPI terminated its contract with Werr.<sup>80</sup>

Werr filed a Complaint for arbitration against HPI before the CIAC to recover the balance of its retention money.<sup>81</sup> By way of counterclaim, HPI prayed for the payment of liquidated damages for the 44-day delay in the completion of the project reckoned from 15 October 2006 up to the termination of the Agreement on 28 November 2006.<sup>82</sup>

CIAC granted Werr's claim for the balance of the retention money and arbitration costs.<sup>83</sup> It also granted HPI's claim for liquidated damages due to 9,327 days of delay.<sup>84</sup> Citing Article 1376 of the Civil Code, it applied the industry practice that liquidated damages do not accrue after achieving substantial compliance.<sup>85</sup> It held that delay should be counted from 27 October 2006 until the projected date of substantial completion.<sup>86</sup> The liquidated damages under the Agreement being ₱271,797.90 per day of

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75. *Id.*

76. *Id.* at 150.

77. *Id.*

78. *Id.*

79. *Werr Corporation International*, 817 SCRA at 150.

80. *Id.*

81. *Id.* at 150-51.

82. *Id.* at 151.

83. *Id.* at 151-52.

84. *Id.* at 152.

85. *Werr Corporation International*, 817 SCRA at 153 (citing CIVIL CODE, art. 1376).

86. *Werr Corporation International*, 817 SCRA at 153.

delay, Werr is liable for liquidated damages in the amount of ₱2,535,048.95.<sup>87</sup> The CA reasoned, however, that delay should be computed from 27 October 2006 until termination of the contract on 28 November 2006, or 33 days, since the contract prevails over the industry practice.<sup>88</sup> Thus, the total liquidated damages is ₱8,969,330.70.<sup>89</sup>

The Court was tasked to resolve the issue of “whether the industry practice of computing liquidated damages only up to substantial completion of the project applies in the computation of liquidated damages. Consequently, whether delay should be computed until termination of the contract or until substantial completion of the project.”<sup>90</sup>

Werr, as contractor, urged the Court to apply the supposed construction industry practice that liquidated damages do not accrue after the date of substantial completion of the project, as evidenced in CIAP Document 102.<sup>91</sup> It cited

[t]he pertinent provision on liquidated damages [which] is found in clause 41.5 of the Agreement, [viz —]

41.5. Considering the importance of the timely completion of the WORKS on the OWNER’S commitments to its clients, the CONTRACTOR agrees to pay the OWNER liquidated damages in the amount of [one-tenth] of [one percent] of the amount of the Contract price for every day of delay (inclusive of Sundays and holidays).<sup>92</sup>

The Court held that “[d]eemed incorporated into every contract are the general provisions on obligations and interpretation of contracts found in the [New] Civil Code,” particularly Article 1234 on substantial performance and Article 1376 on usage and custom.<sup>93</sup>

The Court, through Justice Francis H. Jardeleza, held that it was error for the CA to immediately dismiss the application of industry practice on the sole ground that there is an existing agreement as to liquidated damages.<sup>94</sup>

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87. *Id.* at 154.

88. *Id.*

89. *Id.*

90. *Id.* at 156.

91. *Id.* at 161.

92. *Werr Corporation International*, 817 SCRA at 160-61.

93. *Id.* at 162.

94. *Id.* at 163.



“As expressly stated under Articles 1234 and 1376[ ] and in jurisprudence, the construction industry’s prevailing practice may supplement any ambiguities or omissions in the stipulations of the contract.”<sup>95</sup>

Thus, CIAP Document 102 was made to apply suppletorily to private construction contracts to remedy the conflict in the internal documents of, or to fill in the omissions in, the construction agreement.<sup>96</sup>

While clause 41.5 [of the contract] requires payment of liquidated damages if there is delay, it is silent as to the period until when liquidated damages shall run. The Agreement does not state that liquidated damages is due until termination of the project. This omission in the Agreement may be supplemented by the provisions of the Civil Code, industry practice, and the CIAP Document[ ]102. Hence, the industry practice that substantial compliance excuses the contractor from payment of liquidated damages applies to the Agreement.<sup>97</sup>

Nevertheless, Werr cannot benefit from the effects of substantial compliance.<sup>98</sup> Both CIAP Document 102 and an application of industry practice under Article 1234 require that the contractor completes 95% of the work for there to be substantial completion of the project.<sup>99</sup>

There is no dispute that Werr failed to prove that it completed 95% of the project before or at the time of the termination of the contract ... Werr cannot claim benefit for it failed to meet the condition precedent, i.e., the contractor has successfully proven that it actually achieved 95 percent completion rate. More importantly, Werr failed to show that it is the construction industry’s practice to project the date of substantial completion of a project, and to compute the period of delay based on the rate in past progress billings just as what the CIAC has done.<sup>100</sup>

Hence, Werr’s petition was denied. The period of delay in computing liquidated damages was to be reckoned from 27 October 2006 until the termination of the contract, or for 33 days, and not only until the projected substantial completion date.<sup>101</sup>

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95. *Id.*

96. *Id.* at 164.

97. *Id.*

98. *Werr Corporation International*, 817 SCRA at 164.

99. *Id.* at 164-65.

100. *Id.* at 165-66.

101. *Id.* at 166.

It is in *Werr Corporation International* that the antithetical natures of substantial performance and liquidated damages are made transparent. However, in the matter of prevalence, the Court has sided with legal, as opposed to contractual, provisions. The Court also made an interesting caveat in this case when it said that the provision on substantial performance only aids interpretation,<sup>102</sup> alluding to the necessity of some ambiguity prior to the invocation of the doctrine espoused. Be that as it may, the dissonance in the Court's holding and the factual milieu is the bedrock of confusion, for no ambiguity in fact exists in the stipulation of the parties, and if there be any, it is imagined.

Recall that the stipulation of the parties regarding liquidated damages for delay in *Werr Corporation International* was that "HPI has the right to liquidated damages in the event of delay in the construction of the project equivalent to [one-tenth] of [one percent] of the contract price for every day of delay."<sup>103</sup> The Court was of the opinion that ambiguity calling for the supplementary application of CIAP Document 102 rested on the fact that the provision lacked a running period for delay, forcing it to ask whether the delay shall be counted until completion or until substantial performance. How could a stipulation seeking full performance only contemplate 95% completion?

*D. Emergent Rules in the Appreciation of Substantial Completion in Construction Contracts vis-à-vis Liquidated Damages*

The issue of whether a contractor should be held liable for liquidated damages resulting from delay in case of substantial completion has been resolved in the negative, holding that substantial completion extinguishes the obligation to which the provision on liquidated damages is attached to.<sup>104</sup> The calculation of liquidated damages is thus reckoned from default until the contractor achieves the 95% threshold for substantial completion.<sup>105</sup>

The underlying premise which gave birth to the doctrinal pronouncements in *Werr Corporation International* would render inutile a stipulation for liquidated damages arising from delay, the very purpose thereof is to ensure full performance of the obligation. In ruling that delay only runs until 95% of the project is completed and/or that there is no delay beyond completion of 95%, the Court failed to consider and fully appreciate

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102. *Id.* at 162.

103. *Id.* at 149.

104. See *Werr Corporation International*, 817 SCRA 145.

105. *Id.*

the parties' *raison d'être* in providing for some indemnity and/or penalty for delay in completion.

With all due respect to the Honorable Court, it must abandon the doctrine for reasons articulated below.

### III. FREEDOM OF CONTRACT

It is argued that the freedom of contract must prevail over equity when the stipulation on liquidated damages is neither iniquitous nor unconscionable, there being an express rejection of substantial performance by the very stipulation on liquidated damages arising from delay.

#### *A. Freedom of Contract as a Political, Civil, and Commercial Law Concept*

In *Morla v. Belmonte*,<sup>106</sup> the Court had the occasion to say that “[t]he freedom of contract is both a constitutional and statutory right, and the contracting parties may establish such stipulations, clauses, terms[,] and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order[,] or public policy.”<sup>107</sup>

The 1987 Philippine Constitution provides the constitutional basis upon which the freedom of contract or the liberty of contract may stand, *viz* —

SECTION 1. No person shall be deprived of life, liberty, or property without due process of law, nor shall any person be denied the equal protection of the laws.

...

SECTION 10. No law impairing the obligation of contracts shall be passed.<sup>108</sup>

The more ancient origin of the liberty of contract draws from the Constitution of the United States of America (U.S.), whose legal tradition has been inherited, in part, by the Philippine legal system. In discussing the liberty of contract, the U.S. Supreme Court has said that “[t]he general right to make a contract in relation to his [or her] business is part of the liberty of the individual protected by the Fourteenth Amendment of the Federal Constitution. Under that provision[,] no State can deprive any person of life,

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106. *Merla v. Belmonte*, 661 SCRA 717 (2011).

107. *Id.* at 730 (citing *Rivera v. Solidbank Corporation*, 487 SCRA 512, 538 (2006) (citing *Government Service Insurance System v. Province of Tarlac*, 417 SCRA 60, 64 (2003)) & CIVIL CODE, art. 1306)).

108. PHIL. CONST. art. III, §§ 1 & 10.

liberty[,] or property without due process of law.”<sup>109</sup> The freedom of contract is *apropos* to the right of men and women to manage their affairs without interference from the state. “The idea that unlimited freedom of making promises was a natural right came after enforcement of promises when made, had become a matter of course. It began as a doctrine of political economy.”<sup>110</sup> Liberty of contract as a constitutional right looks into the demands of public interest as they bear upon the upholding or the striking down of state intervention in contractual relations. Upon this invocation of public interest lies the state’s justification in providing for some limitations to such rights.

The statutory basis of the liberty of contract is found in the Civil Code, thus —

Art. 1305. A contract is a meeting of minds between two persons whereby one binds himself, with respect to the other, to give something or to render some service. (1254a)

Art. 1306. The contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy. (1255a)<sup>111</sup>

The Court has taken the provisions to mean that “[a]s long as the terms of the contract are not contrary to law, morals, good customs, public order[,] or public policy, they shall be respected by courts. The judiciary is not authorized to make or modify contracts; neither may it rescue parties from disadvantageous stipulations.”<sup>112</sup> As a civil law concept, the liberty of contract focuses on the internal relation of parties. As a commercial law concept, the liberty of contract goes into the spirit that moves much of contractual relations today: the need for goods and services. The matter is discussed in this wise —

The modern *lex mercatoria* doctrine emerged for the restoration of the liberal and spontaneous order of international commerce, which was disturbed by the political debates about whether the society should be framed along the lines of market economy or state economy. This political debate gradually died down during the last decades of the twentieth century. Today[,] there seems to be a widespread consensus among the

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109. *Lochner v. New York*, 198 U.S. 45, 53 (1905).

110. Roscoe Pound, *Liberty of Contract*, 18 YALE L.J. 454, 456 (1908-1909).

111. CIVIL CODE, arts. 1305-1306.

112. *Pryce Corporation v. Philippine Amusement and Gaming Corporation*, 458 SCRA 164, 166 (2005).

national legal systems about the freedom of contract and belief that the freedom of contract will encourage entrepreneurial spirit, that it will increase production, that it is one of the causes of wealth, and that it was the lack of this freedom which[,] among other things[,] caused the poverty of socialist states.<sup>113</sup>

At all points in the above discussion, it is clear that the liberty of contract is far from absolute. The *greater good* rhetoric enters the picture to limit the contractual and contracting rights of individuals.

### *B. State Regulation of Contract Relations*

In his 1909 critique, Dean Nathan Roscoe Pound, a distinguished legal scholar and educator, attributed the development of constitutional decisions on the liberty of contract upon the following:

- (1) The currency in juristic thought of an individualist conception of justice, which exaggerates the importance of property and of contract, exaggerates private right at the expense of public right, and is hostile to legislation, taking a minimum of law-making to be the ideal;
- (2) what [he or she has] ventured to call on another occasion a condition of mechanical jurisprudence, a condition of juristic thought and judicial action in which deduction from conceptions has produced a cloud of rules that obscures the principles from which they were drawn, in which conceptions are developed logically at the expense of practical results and in which the artificiality characteristic of legal reasoning is exaggerated;
- (3) the survival of purely juristic notions of the state and of economics and politics as against the social conceptions of the present;
- (4) the training of judges and lawyers in eighteenth century philosophy of law and the pretended contempt for philosophy in law that keeps the legal profession in the bonds of the philosophy of the past because it is to be found in law-sheep bindings[;]
- (5) the circumstance that natural law is the theory of our bills of rights and the impossibility of applying such a theory except when all men [and women] are agreed in their moral and economic views and look to a single authority to fix them;
- (6) the circumstance that [the] earlier labor legislation came before the public was prepared for it, so that the courts largely voiced well-meant but unadvised protests of the old order against the new, at a time when the public at large was by no means committed to the new; and

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113. MERT ELCIN, *LEX MERCATORIA IN INTERNATIONAL ARBITRATION THEORY AND PRACTICE* 191 (2012).

- (7) by no means least, the sharp line between law and fact in our legal system which requires constitutionality, as a legal question, to be tried by artificial criteria of general application and prevents effective judicial investigation or consideration of the situations of fact behind or bearing upon the statutes.<sup>114</sup>

In his efforts to lay down a case for a more people-centric and less highfaluting understanding of the liberty of contract, Dean Pound argued for reasonable state regulation in contractual relations, especially as it relates to labor saying that the theoretical foundations of the liberty of contract, which is the free will of men and women, is distorted under a situation of necessity thus necessitating some form of state protection.<sup>115</sup> In the years that followed Dean Pound's seminal work, government became more involved in contract relations which touch upon public interest. In its current formulation, while the liberty of contract remains a function of free will, the state is not precluded from interfering when the public good is shown to bear upon the promises made.

Be that as it may, the initial approach to contractual and contracting rights remain to be the liberty of contracts as can be seen in the full citation of the doctrine pronounced in *Lochner v. New York*,<sup>116</sup> viz —

The general right to make a contract in relation to his [or her] business is part of the liberty of the individual protected by the Fourteenth Amendment of the Federal Constitution. Under that provision[,] no State can deprive any person of life, liberty[,] or property without due process of law. The right to purchase or to sell labor is part of the liberty protected by this amendment, unless there are circumstances which exclude the right. There are, however, certain powers, existing in the sovereignty of each State in the Union, somewhat vaguely termed police powers, the exact description and limitation of which have not been attempted by the courts. Those powers, broadly stated and without, at present, any attempt at a more specific limitation, relate to the safety, health, morals and general welfare of the public. Both property and liberty are held on such reasonable conditions as may be imposed by the governing power of the State in the exercise of those powers, and with such conditions the Fourteenth Amendment was not designed to interfere.<sup>117</sup>

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114. Pound, *supra* note 110, at 457-58.

115. *Id.*

116. *Lochner v. New York*, 198 U.S. 45 (1905) (U.S.).

117. *Id.* at 53.

The same is true in this jurisdiction as enunciated by the Court in *Pryce Corporation v. Philippine Amusement and Gaming Corporation*,<sup>118</sup> thus —

As long as the terms of the contract are not contrary to law, morals, good customs, public order[,] or public policy, they shall be respected by courts. The judiciary is not authorized to make or modify contracts; neither may it rescue parties from disadvantageous stipulations. Courts, however, are empowered to reduce iniquitous or unconscionable liquidated damages, indemnities[,] and penalties agreed upon by the parties.<sup>119</sup>

This intervention comes in the form of statutory aids to construction and interpretation,<sup>120</sup> standard contract provisions,<sup>121</sup> and judicial incisors to relieve parties from contractual obligations.<sup>122</sup> The Court, in the cases of *Diesel Construction Co., Inc.*, *Transcept Construction and Management Professional Inc.*, and *Werr Corporation International*, animated state intervention in contract relations by waiving on behalf of one party the entitlement to claim liquidated damages arising from delay, citing rules of interpretation and construction.<sup>123</sup> The question would be — in cases where substantial completion is pleaded against a claim for liquidated damages, there being no stipulation on substantial completion, which between the liberty of contract and state intervention must prevail?

The Court has answered the question in favor of state intervention, saying that Articles 1234 and 1376 of the Civil Code have empowered it to conduct an exercise in construction and read into the construction contracts

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118. *Pryce Corporation v. Philippine Amusement and Gaming Corporation*, 458 SCRA 164 (2005).

119. *Id.* at 166-67.

120. *See, e.g.*, A Decree Instituting a Labor Code Thereby Revising and Consolidating Labor and Social Laws to Afford Protection to Labor, Promote Employment and Human Resources Development and Insure Industrial Peace Based on Social Justice [LABOR CODE], Presidential Decree No. 442, art. 253 (1974) (as amended).

121. *See, e.g.*, An Act Providing for the Modernization, Standardization and Regulation of the Procurement Activities of the Government and for Other Purposes [Government Procurement Reform Act], Republic Act No. 9184, art. XVIII, § 59 (2003).

122. *See, e.g.*, *Trade & Investment Development Corporation of the Phils. v. Roblett Industrial Construction Corporation*, 490 SCRA 1 (2006).

123. *See Diesel Construction Co., Inc.*, 549 SCRA at 28-29; *Transcept Construction and Management Professionals, Inc.*, 637 SCRA at 581-82; & *Werr Corporation International*, 817 SCRA at 164.

in question CIAP Document 102's Section 20.11. The Authors respectfully disagree.

*C. Freedom of Contract and Equity*

The liberty of contract is a primordial consideration in the relations of people. It is the sanctity of promise that allows for the ebb and flow of social and commercial relations that breathe life to the activities of the nation. It is only in cases where law, morals, good customs, and public policy are endangered that the liberty of contract yields to public interest. Under the strictures of law, there must be some showing that damage to the public will result if the liberty of contract clause is upheld against some plea for state action upon the agreement. In the present case, no such public interest warrants the interference. The doctrine thus pronounced makes a case for interventionism when none is authorized nor necessary.

Foremost, the judiciary's power of intervention over contractual stipulations for liquidated damages is limited to:

- (1) a determination of the breach contemplated in the stipulation for liquidated damages;<sup>124</sup>
- (2) a determination of the fact of breach resulting in liability;<sup>125</sup> and
- (3) a determination of iniquitousness or unconscionability.<sup>126</sup>

Absent the last two, the courts must be wary of nullifying such stipulations, save only in cases when the entire contract is voided or made unenforceable. Thus, in cases where the application of the general provisions of Articles 1234 and 1376 would preempt the appeal to the specific provisions of Articles 2226 to 2228 of the Civil Code, the former must yield to the latter under the rules of statutory construction which speak of later rules having greater control than earlier ones, and more specific rules trumping general ones. And, as between the limitations under Articles 2226 to 2228 of the Civil Code and the provisions of Section 20.11 of CIAP Document 102, the former has greater weight in law for being a legislative enactment having the force and effect of law, as opposed to an administrative issuance adopted as recommendatory.

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124. See generally *J Plus Asia Development Corporation v. Utility Assurance Corporation*, 700 SCRA 134 (2013).

125. *Id.*

126. *Id.*



Second, the rule on integration must work to the benefit of the party claiming under the contract as opposed to another claiming under general laws. The contract is law between the parties, and when the agreements have been reduced to writing, it is presumed that the document contains all the terms which the parties agreed upon.<sup>127</sup> Thus, construction contracts that fail to incorporate the substantial completion provision recommended under CIAP Document 102 may not be supplemented thereby, the assumption being that the parties have foregone the benefits arising thereby, i.e., constructive completion.

Third, and as will be shown in the subsequent Section of this Article, a stipulation on liquidated damages, without more, is one geared towards full completion of the undertaking for which no substantial completion can be had, at least in the matter of damages arising from delay.

The legal scholar, Irving M. Mehler, eloquently surfaced the clash of the above ideas in this wise —

In this contentious area of substantial performance versus freedom of contract, let our courts be ever alert to their guardian duties as conservators of a great heritage of freedom under law of which freedom of contract is an integral part ... [T]he court is duty[-]bound to consider every incident by which the property offered can be differentiated from that contracted for, with the ultimate aim that a promisee shall have that which he [or she] contracted for, or not be compelled to take that which he [or she] did not intend to have. And finally, if there is one thing more than any other which public policy requires, it is that men [and women] of full age and competent understanding shall have the utmost liberty to contract, and that contracts, when entered into freely and voluntarily, shall be held good and shall be enforced by courts of justice fully in accordance with the terms and conditions agreed upon by the parties.<sup>128</sup>

In all, the weight of authority falls against the courts' favoring equity jurisdiction over upholding the freedom of contract, by virtue of which the desirability of full and actual performance of an undertaking is maintained.

#### IV. SUBSTANTIAL PERFORMANCE AND LIQUIDATED DAMAGES

As adverted to in the previous Section, the legal histories of the substantial performance provision and liquidated damages show that substantial

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127. See 1989 REVISED RULES ON EVIDENCE, rule 130, § 9.

128. Irving M. Mehler, *Substantial Performance Versus Freedom of Contract*, 33 BROOK. L. REV. 196, 218 (1967) (citing *Pfeil Constr. Corp. v. Moley*, 14 Misc. 2d 379 (1958) (U.S.) & *Valley Etc. Co. v. Lake Hills Sewer Dist.*, 410 P. 2d 796 (1966) (U.S.)).

performance cannot prevail over a stipulation on liquidated damages arising from delay.

*A. The History and Purpose of the Substantial Performance Provision*

Substantial performance has been taken to mean

not doing the exact thing promised, but doing something else that is just as good, or good enough for obligor and obligee ... 'Substantial performance exists where there has been no [willful] departure from the terms of the contract, and no omission in essential points and the contract has been honestly and faithfully performed in its material and substantial particulars, and the only variance from the strict and literal performance consists of technical or unimportant omissions or defects.'<sup>129</sup>

Prescinding from the above characterization, the following have been held to be beyond the ambit of the doctrine of substantial performance:

- A. Performance of substantial value as distinct from substantial performance of the overall contract requirements;
- B. Deficiencies so negligible as to fall under the rule of '*de minimis non curat lex*.' In such instances, the full contract price would ordinarily be payable;
- C. Deficiencies so serious as to deprive the property of its value for the intended use; and
- D. Deficiencies so [pervading] the whole work that a mere deduction in damages would not be equitable.<sup>130</sup>

There is great consensus that "the doctrine of substantial performance is equitable in origin, but was carried over into the common law by many courts that desired to mollify the rigors of the rule insisting on exact performance."<sup>131</sup> Its earliest iteration is found in the case of *Boone v. Eyre*.<sup>132</sup> In that case, the transferor agreed to convey the plantation and the slaves thereon to the transferee upon the latter's promise to pay the seller an

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129. Peter D. Hyman, *Substantial Performance of Builder's Contracts*, 5 S.C.L.Q. 442, 443 (1953) (citing BLACK'S LAW DICTIONARY 1671 (3D ed. 1933)).

130. Harry Gaberman, *Substantial Performance*, 5 U.S.A.F. JAG BULL. 22, 23 (1963) (citing ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS §§ 703, 706, 707, & 711 (1952) & SAMUEL WILLISTON, WILLISTON ON CONTRACTS §§ 703 & 805 (1920)).

131. Mehler, *supra* note 128, at 200.

132. *Boone v. Eyre*, 126 Eng. Rep. 160 (a) (1777) (Eng.).

annuity.<sup>133</sup> The transferee disclaimed liability saying that the title to the slaves was defective.<sup>134</sup> In finding for the transferee, Lord William Murray, 1st Earl of Mansfield (or simply Lord Mansfield), opined that

‘The distinction is very clear, where mutual covenants go to the whole of the consideration on both sides, they are mutual conditions ... But where they go only to a part, where a breach may be paid for in damages, there the defendant has a remedy on his [or her] covenant and shall not plead it as a condition precedent.’<sup>135</sup>

As it developed, its application became forked, *viz* —

One doctrine of substantial performance applies to contracts for the sale of land and is of purely equitable creation. Another doctrine of this name is often applied to adjust a promisor’s delay or unpunctual performance and has its roots both in common law and equity. A third doctrine of substantial performance is almost exclusively connected with contracts of building or work and [labor]; and indeed, whenever we think of ‘substantial performance’ we first think of its applicability to a builder.<sup>136</sup>

The doctrine evolved through a long line of case law which built upon the pronouncement in *Boone*, reaching the conception that would later find its way to Philippine shores.<sup>137</sup>

In Philippine jurisdiction, the doctrine has been codified as Article 1234 of the Civil Code, which provides that “[i]f the obligation has been substantially performed in good faith, the obligor may recover as though there had been a strict and complete fulfillment, less damages suffered by the obligee.”<sup>138</sup> The rule was adopted from American law from whence, as earlier illustrated, it grew as a doctrine of equity.<sup>139</sup>

Justice Edgardo L. Paras maintains that substantial performance precludes the right to rescind; the law presumes the obligation to have been fulfilled or

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133. Mehler, *supra* note 128, at 201 (citing *Boone*, 126 Eng. Rep. 160 (a)).

134. *Id.*

135. *Id.*

136. Samuel J. Stoljar, *Substantial Performance in Building and Work Contracts*, 2 U.W. AUSTL. ANN. L. REV. 293 (1955).

137. See Anthony Beck, *The Doctrine of Substantial Performance: Conditions and Conditions Precedent*, 38 MOD. L. REV. 413 (1975).

138. CIVIL CODE, art. 1234.

139.4 EDGARDO L. PARAS, CIVIL CODE OF THE PHILIPPINES ANNOTATED PRESCRIPTION; OBLIGATIONS AND CONTRACTS ARTICLES 1106-1457, 351 (2016).

paid.<sup>140</sup> In his discussion, he has pointed to the application of the doctrine “only when an obligor admits breaching the contract after honestly and faithfully performing all the material elements thereof except for some technical aspects that cause no serious harm to the [obligees].”<sup>141</sup> Dean Melencio S. Sta. Maria, Jr. echoes Justice Paras’ test of materiality of breach as a precondition to the application of the doctrine saying that “the part unperformed must not destroy the value or purpose of the contract.”<sup>142</sup> He also emphasizes the element of good faith in determining whether the doctrine should be applied.<sup>143</sup> Professor Ruben F. Balane, a renowned scholar in civil law, says that substantial performance may constitute an exception to the rule of integrity.<sup>144</sup> Section 20.11 of CIAP Document 102 itself requires that “the remaining work and the performance of the work necessary to complete the Work shall not prevent the normal use of the completed portion” for the rule on substantial completion to apply.

From equity it came, and to equity it appeals. Thus, as illustrated in the cases subject matter of this inquiry, the application of the doctrine is almost always premised upon the equity jurisdiction of the Court, that is to say, the power to adjudicate parties’ rights primarily on *just and equitable* grounds. The effect of substantial performance is the extinguishment of the obligation. To the mind of the Court, this forthcoming extinguishment from the application of the doctrine prevents the occurrence or continuation of delay on the part of the obligor, the obligation having been constructively fulfilled.

#### *B. The History and Purpose of Stipulations on Liquidated Damages*

The legal provisions specifically dealing with liquidated damages are found in Book IV, Title XVIII of the Civil Code:

Art. 2226. Liquidated damages are those agreed upon by the parties to a contract, to be paid in case of breach thereof.

Art. 2227. Liquidated damages, whether intended as an indemnity or a penalty, shall be equitably reduced if they are iniquitous or unconscionable.

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140. *Id.*

141. *Id.* at 352 (citing *International Hotel Corporation v. Joaquin, Jr.*, 695 SCRA 382, 397 (2013)).

142. MELENCIO S. STA. MARIA, JR., *OBLIGATIONS AND CONTRACTS TEXT AND CASES* 273 (2017) (citing JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW ON CONTRACTS* 462 (3d ed. 1987)).

143. STA. MARIA, *supra* note 142, at 274.

144. RUBEN F. BALANE, *JOTTINGS AND JURISPRUDENCE (OBLIGATION AND CONTRACT)* 315 (2018).

Art. 2228. When the breach of the contract committed by the defendant is not the one contemplated by the parties in agreeing upon the liquidated damages, the law shall determine the measure of damages, and not the stipulation.<sup>145</sup>

The provisions clearly set out that “liquidated damages can only exist if there is a contract or agreement between the [parties].”<sup>146</sup> Atty. Timoteo B. Aquino, author and legal scholar, discusses the concept of liquidated damages in his book on Torts and Damages thusly —

[L]iquidated damages ‘[are] attached to an obligation in order to ensure performance and has a double function: (1) to provide for liquidated damages, and (2) to strengthen the coercive force of the obligation by the threat of greater responsibility in the event of breach.’ Based on the report of the Code Commission, liquidated damages are either (1) penalty or (2) a fixed amount of recovery without proof. Hence, liquidated damages are governed by the same rules that are applicable to obligations with penal clause.<sup>147</sup>

Liquidated damages being contractual in nature,

the court cannot[, ordinarily,] change the amount of liquidated damages agreed upon by the parties. ‘In American law, it is only when the clause is a penalty that the courts will reduce the stipulated damages that are excessive.’ However, Article 2227 of the Civil Code provides that liquidated damages, whether intended as an indemnity or a penalty, shall be equitably reduced if they are iniquitous or unconscionable. The Code Commission explained why the stipulated liquidated [damages] should be reduced if the same is iniquitous or unconscionable[, in this wise —]

[T]he reason is that in both cases, the stipulation is *contra bonus mores* under Article 1326. It is a mere technicality to refuse to lessen the damages to their just amount simply because the stipulation is not meant to be a penalty. An immoral stipulation is not the less immoral because it is called an indemnity[.]<sup>148</sup>

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145. CIVIL CODE, arts. 2226–2228.

146. ROMMEL J. CASIS, ANALYSIS OF PHILIPPINE LAW AND JURISPRUDENCE ON DAMAGES 255 (2012).

147. TIMOTEO B. AQUINO, TORTS AND DAMAGES 851 (4th ed. 2016) (citing Atlantic Erectors, Inc. v. Court of Appeals, 684 SCRA 55, 65 (2012); Lambert v. Fox, 26 Phil. 588, 592 (1914); & Joe’s Radio & Electrical Supply v. Alto & Electronics Corp., 104 Phil. 333 (1958)).

148. AQUINO, *supra* note 147, at 85 (citing Code Commission Report, at 625 & CIVIL CODE, art. 1306)

In relation to construction contracts, Aquino says that

[a] stipulation on liquidated damages is a standard provision in construction contract[s]. *A client's entitlement to liquidated damages is distinct from its right to terminate the contract.* The contractor's liability for liquidated damages is not inconsistent with [the] client's takeover of the project. Or termination of the contract or even the eventual completion of the project. *What is decisive of such entitlement is the fact of delay in the completion of the works.* Stated in simple terms, *as long as the contractor fails to finish the works within the period agreed upon by the parties without justifiable reason and after the owner makes a demand, then liability for damages as a consequence of such default arises.*<sup>149</sup>

In *Atlantic Erectors, Inc. v. Court of Appeals*<sup>150</sup> cited by Aquino, Atlantic Erectors, Inc. (Atlantic Erectors) entered into a Construction Contract with Herbal Cove, whereby it agreed to implement and finish a construction plan for the Respondent's subdivision project known as "The Herbal Cove."<sup>151</sup> Article IX, Section 1 of the contract provides that

[t]he CONTRACTOR hereby expresses, covenants[,] and agrees to pay to the Owner liquidated damages equivalent to the [o]ne-[t]enth of [o]ne [p]ercent (1/10 of 1%) of the Contract Price per calendar day of delay until completion, delivery[,] and acceptance of the said Works by the OWNER to a maximum amount not to exceed 10%.<sup>152</sup>

Atlantic Erectors asked for two successive extensions for excusable reasons, i.e., belated turnover of the sites and bad weather conditions.<sup>153</sup> However, it still failed to accomplish the project within the dates agreed upon and despite the reminder that liquidated damages will apply after the extended period.<sup>154</sup> Herbal Cove's management decided to terminate the Construction Contract, citing as one of the reasons the "delayed completion of the project."<sup>155</sup> Herbal Cove contracted the service of another company

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149. AQUINO, *supra* note 147, at 852-53 (citing *Asia Construction and Development Corporation v. Cathay Pacific Steel Corporation (CAPASCO)*, 622 SCRA 122 (2010); *H.L. Carlos Construction, Inc. v. Marina Properties Corporation*, 421 SCRA 428, 445 (2004); & *Atlantic Erectors, Inc.*, 684 SCRA at 69) (emphases supplied).

150. *Atlantic Erectors, Inc. v. Court of Appeals*, 684 SCRA 55 (2012).

151. *Id.* at 57.

152. *Id.* at 66.

153. *Id.* at 58.

154. *Id.*

155. *Id.* at 59.

to finish the housing units.<sup>156</sup> Thereafter, it filed a Request for Arbitration with the CIAC against Atlantic Erectors, praying for the payment of liquidated damages, among others.<sup>157</sup> Atlantic Erectors argued that the alleged delay was for justifiable reasons and that the respondent unlawfully terminated the Construction Contract.<sup>158</sup>

The CIAC ruled that the Atlantic Erectors incurred delay, but the termination of the contract was unlawful because of the failure of the Herbal Cove to give the 15-day notice before the termination, as required by the contract.<sup>159</sup> Hence, respondent was not awarded liquidated damages.<sup>160</sup> But in view of the proven and admitted defects, reasonable cost was awarded in its favor.<sup>161</sup> Both parties' counterclaims were partially granted.<sup>162</sup>

Atlantic Erectors filed an appeal and a subsequent motion for reconsideration, which were both denied by the CA.<sup>163</sup> On a separate appeal by the Herbal Cove, the CA affirmed the CIAC decision and modified it by awarding Herbal Cove liquidated damages of ₱1,572,674.51, for which Atlantic Erectors is nonetheless liable due to the delay in the completion of the project.<sup>164</sup>

The issue before the Court was whether Atlantic Erectors was liable for liquidated damages, which was resolved in the affirmative. The Court cited Articles 2226 to 2228 of the Civil Code and said that

[b]ased on the above provisions of law, the parties to a contract are allowed to stipulate on liquidated damages to be paid in case of breach ... . The amount agreed upon answers for damages suffered by the owner due to delays in the completion of the project. As a pre-condition to such award, however, there must be proof of the fact of delay in the performance of the obligation.<sup>165</sup>

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156. *Atlantic Erectors, Inc.*, 684 SCRA at 59.

157. *Id.*

158. *Id.* at 60.

159. *Id.* at 61.

160. *Id.* at 62.

161. *Id.*

162. *Atlantic Erectors, Inc.*, 684 SCRA at 62.

163. *Id.*

164. *Id.* at 62-63.

165. *Id.* at 65 (citing *H.L. Carlos Construction, Inc.*, 421 SCRA at 445; *Empire East Land Holdings, Inc. v. Capitol Industrial Construction Groups, Inc.*, 566 SCRA 473, 489 (2008); & CIVIL CODE, arts. 2226-2228).

The Court further held that based on the relevant provisions in the contract and, as correctly held by the CA, rights to liquidated damages and termination of contract were separate remedies that the Herbal Cove was free to avail.<sup>166</sup> Section 1 in the subject contract expressly provided for the remedy of liquidated damages and specified the rate thereof.<sup>167</sup> Under Section 4 of the contract “[t]he obligation of the CONTRACTOR to pay damages due to unexcused delays shall not relieve it from the obligation to complete and finish the performance of the Works, and to secure the final certificate of inspection from the proper government authorities.”<sup>168</sup> The liability for damages is further elaborated in Article 21.05 and Article 29.04, thus —

Article 21.05. It is understood that time is an essential feature of this Contract, and that upon failure to complete the said Contract within the contract time, the Contractor shall be required to pay the Owner the liquidated damages in the amount stipulated in the Contract Agreement, the said payment to be made as liquidated damages, and not by way of penalty.

Article 29.04 Neither the taking over by the Owner of the work for completion by administration nor the re-letting of the same to another Contractor shall be construed as a waiver of the Owner’s rights to recover damages against the original Contractor and/or his sureties for the failure to complete the work as stipulated.<sup>169</sup>

The Court said that the fact of delay, once proven, justifies the award of liquidated damages.<sup>170</sup> “[A]s long as the contractor fails to finish the works within the period agreed upon by the parties without justifiable reason and after the owner makes a demand, then liability for damages as a consequence of such default arises.”<sup>171</sup> In this case, Atlantic Erectors failed to finish the housing units within the period initially agreed upon as well as within the extension period granted by Herbal Cove.<sup>172</sup> Moreover, it was duty-bound in the contract to send a written request for extension, which it did not do before the last extension expired.<sup>173</sup> Under General Conditions in Article

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166. *Atlantic Erectors, Inc.*, 684 SCRA at 69.

167. *Id.* at 66.

168. *Id.* at 66-67.

169. *Id.* at 68.

170. *Id.* at 69.

171. *Id.*

172. *Atlantic Erectors, Inc.*, 684 SCRA at 69.

173. *Id.* at 70.



21.04, “the time allowance for any extension and increases shall be agreed upon in writing.”<sup>174</sup>

Under the circumstances, Atlantic Erector’s liability for liquidated damages arose, which is 1/10 of 1% of the contract price per calendar day of delay to a maximum amount of 10% of the contract price.<sup>175</sup> The Court decided to sustain the maximum amount and found that a deduction due to partial fulfillment or unconscionable amount is not warranted this case.<sup>176</sup> According to CIAC findings, it only accomplished its work by 62.57%.<sup>177</sup>

In fine, the Court applied “the general rule not to ignore the freedom of the parties to agree on such terms and conditions as they see fit as long as they are not contrary to law, morals, good customs, public order[,] or public policy.”<sup>178</sup>

### C. Substantial Performance vis-à-vis Liquidated Damages

Lawyer, industrial specialist, and business economist Harry Gaberman opines that “[w]here there is provision for liquidated damages in the contract, same may not be levied in the face of a showing of substantial performance.”<sup>179</sup> However, there is much to be desired in his juxtaposition of these doctrines, failing, as he did, to discuss the logic behind his characterization. Perhaps the following passage from Mehler is enlightening in discussing Gaberman’s position, to wit —

From a theoretical point of view, it has been maintained that to whatever degree strict performance of an express condition is necessary to put the promisor in default, it would seem that a constructive condition is fulfilled if the promisee has substantially, even though not completely, performed on his [or her] side. Accordingly, it has been argued that since it is the law that constructs the condition and not the expressed intent of the parties, no difficulty is encountered by the objection that the doctrine of substantial performance, in permitting a recovery, is a departure from the terms of the contract. For only to the extent necessary to effect a just end result need

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174. *Id.*

175. *Id.* at 72.

176. *Id.*

177. *Id.*

178. *Atlantic Erectors, Inc.*, 684 SCRA at 72 (citing *R.S. Tomas, Inc. v. Rizal Cement Company, Inc.*, 668 SCRA 665, 680 (2012)).

179. Gaberman, *supra* note 130, at 24 (citing *United States v. Wunderlich Contracting Company*, 228 F.2d. 66 (10th Cir. 1955) (U.S.)).

the law regard the promisee's substantial performance as a condition to the promisor's duty to perform his [or her] part of the bargain.<sup>180</sup>

However, this discussion from Mehler only surfaces the idea that substantial performance only serves to preclude the remedy of rescission. It is clear to the Authors that the doctrine of substantial completion goes more into: *first*, the right of the obligor/contractor to collect his or her due less actual damages and, *second*, the injunction against the owner from rescinding the contract. It cannot go so far as to bar the collection of liquidated damages. It is submitted in this Article that in cases where substantial performance is levied as a defense against liability for liquidated damages arising from delay, the balance must be tilted in favor of the contractual agreement of the parties, as it is the law between them.

[The doctrine of substantial performance] goes counter to long-established principles of the law of contract, introduces illogicality and adds to injustice. If it is accepted that the basis of contract has 'the great object' of fulfilling the intention of the parties, so far as the public interest permits at least and so far that oppression and unfairness are not enforced by law, there can be no objection to enforcing a provision agreed by the parties that the obligation to pay shall only arise in defined circumstances of complete performance. If the parties have clearly agreed to such a term[,] it is inconceivable that the court can act consistently with the great object without enforcing it. *The role of the court should not be to define substantial performance but what performance in the intention of the parties was to constitute compliance with the condition precedent, if a condition precedent was in fact intended by them.* It has been argued that to treat the matter as one of construction is to invite fictions, but this solution does avoid robbing the phrase condition precedent of its plain meaning, subject to well established approaches of construction which make the court unready to find that such a term was intended, which should be supplemented by the use of quasi-contract to give such relief to the party in breach as is reasonable — unless it was also the intention of the parties that he [or she] should receive no relief in the events which have occurred, unless on equitable principles (like those applied to penalties) relief should nevertheless be granted.<sup>181</sup>

Elsewise stated, "where total performance is expressly conditioned, no partial performance, however substantial, will amount to fulfillment of such condition. For ultimately, the intent of the parties must always govern."<sup>182</sup> It is, therefore, argued that if parties have contracted the payment of liquidated

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180. Mehler, *supra* note 128, at 200.

181. Beck, *supra* note 137, at 427-28 (emphasis supplied).

182. Mehler, *supra* note 128, at 202 (citing *Matter of Ahern v. S. Buffalo Ry. Co.*, 202 N.Y. 545 (N.Y. 1952) (U.S.)).

damages, without incorporating into their agreement a provision on substantial completion, they have expressly conditioned their contract on full performance. The parties, in providing for liquidated damages arising from delay, could have only contemplated full performance to discharge the obligor from the liability incurred therefrom. Thus, just as “[a] client’s entitlement to liquidated damages is distinct from its right to terminate the contract,”<sup>183</sup> so is the contractor’s right to collect on the contract founded on substantial performance separate from its liability for liquidated damages arising from delay. The contract provision must prevail absent a violation of law, morals, good customs, and public policy.

#### V. CONCLUSION

It has been argued that the standing rule that liquidated damages arising from delay are barred by a showing of substantial completion of at least 95% (which is an incorrect application of Section 20.11 anyway) should be abandoned. The reasons for this stand on the most ancient doctrines — the very foundation — of contractual relations.

The freedom of contract must stand against strained interpretations of legal provisions that violate the integrity of contracts. Otherwise stated, substantial performance in good faith, though allowing recovery as if faithfully complied with, less damages, cannot, as it should not affect liability for delay when contracted for and warranted by the facts of each case. While substantial completion precludes the obligee from rescinding or resolving the contract, it cannot bar the recovery of liquidated damages as revealed by the legal histories of both substantial completion and liquidated damages.

Contracts — construction contracts more so — stand and thrive upon the confidence that total completion is forthcoming. This Article, in fact, began with an exposition on the growth of the construction industry in the Philippines. This growth results from the trust that investors have in the return of their investment. A different regime from that advocated herein might work against the construction industry by pulling out the teeth that would otherwise compel a timely performance of the obligation or indemnify the obligor for delay. If at 95%, the contractor can collect 95% of the contract price, with only the five percent as consequence, what motivation will he or she have to complete the project, besides the abstract idea of *reputation*? A pecuniary consequence for non-completion, which requires only proof of delay, is most certainly more attractive to an investor.

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183. *Atlantic Erectors, Inc.*, 684 SCRA at 69.

In closing, the Authors appeal to the erudite words of Justice William W. Story of the U.S. Supreme Court, *viz* —

[T]he express stipulations of a contract must be exactly performed and a substantial compliance is not sufficient where the time or express manner and details agreed upon are essential and not complied with ... [T]he rule is that an agreement must be performed according to its terms as understood and assented to by the parties.<sup>184</sup>

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184. Jon F. Kelly, *Substantial Performance of Contracts*, 19 CENT. L.J. 442 (1884) (citing WILLIAM W. STORY, A TREATISE ON THE LAW OF CONTRACTS 536 (4th ed. 1856)).