

SECOND DIVISION

[G.R. No. 156087, May 08, 2009]

**KUWAIT AIRWAYS, CORPORATION, PETITIONER, PHILIPPINE
AIRLINES, INC., RESPONDENT.**

DECISION

TINGA, J.:

This petition for review^[1] filed by the duly designated air carrier of the Kuwait Government assails a decision^[2] dated 25 October 2002 of the Makati Regional Trial Court (RTC), Branch 60, ordering Kuwait Airways to pay respondent Philippine Airlines the amount of US\$1,092,690.00, plus interest, attorney's fees, and cost of suit.^[3] The principal liability represents the share to Philippine Airlines in the revenues the foreign carrier had earned for the uplift of passengers and cargo in its flights to and from Kuwait and Manila which the foreign carrier committed to remit as a contractual obligation.

On 21 October 1981, Kuwait Airways and Philippine Airlines entered into a Commercial Agreement,^[4] annexed to which was a Joint Services Agreement^[5] between the two airlines. The Commercial Agreement covered a twice weekly Kuwait Airways flight on the route Kuwait-Bangkok-Manila and vice versa.^[6] The agreement stipulated that "only 3rd and 4th freedom traffic rights between Kuwait and Manila and vice versa will be exercised. No 5th freedom traffic rights will be exercised between Manila on the one hand and Bangkok on the other."^[7]

The "freedom traffic rights" referred to in the Agreement are the so-called "five freedoms" contained in the International Air Transport Agreement (IATA) signed in Chicago on 7 December 1944. Under the IATA, each contracting State agreed to grant to the other contracting states, five "freedoms of air." Among these freedoms were "[t]he privilege to put down passengers, mail and cargo taken on in the territory of the State whose nationality the aircraft possesses" (Third Freedom); "[t]he privilege to take on passengers, mail or cargo destined for the territory of the State whose nationality the aircraft possesses" (Fourth Freedom); and the right to carry passengers from one's own country to a second country, and from that country to a third country (Fifth Freedom). In essence, the Kuwait Airways flight was authorized to board passengers in Kuwait and deplane them in Manila, as well as to board passengers in Manila and deplane them in Kuwait. At the same time, with the limitation in the exercise of Fifth Freedom traffic rights, the flight was barred from boarding passengers in Bangkok and deplaning them in Manila, or boarding passengers in Manila and deplaning them in Bangkok.

The Commercial Agreement likewise adverted to the annexed Joint Services Agreement covering the Kuwait-Manila (and vice versa) route, which both airlines had entered into "[i]n order to reflect the high level of friendly relationships between

[Kuwait Airways] and [Philippine Airlines] and to assist each other to develop traffic on the route."^[8] The Agreement likewise stipulated that "[u]ntil such time as [Philippine Airlines] commences its operations to or via Kuwait, the Joint Services shall be operated with the use of [Kuwait Airways] aircraft and crew."^[9] By virtue of the Joint Services Agreement, Philippine Airlines was entitled to seat allocations on specified

Kuwait Airways sectors, special prorates for use by Philippine Airlines to specified Kuwait Airways sectors, joint advertising by both carriers in each other's timetables and other general advertising, and mutual assistance to each other with respect to the development of traffic on the route.^[10]

Most pertinently for our purposes, under Article 2.1 of the Commercial Agreement, Kuwait Airways obligated itself to "share with Philippine Airlines revenue earned from the uplift of passengers between Kuwait and Manila and vice versa."^[11] The succeeding paragraphs of Article 2 stipulated the basis for the shared revenue earned from the uplift of passengers.

The Commercial Agreement and the annexed Joint Services Agreement was subsequently amended by the parties six times between 1981 and 1994. At one point, in 1988, the agreement was amended to authorize Philippine Airlines to operate provisional services, referred to as "*ad hoc* joint services," on the Manila-Kuwait (and vice versa) route for the period between April to June 1988.^[12] In 1989, another amendment was agreed to by the parties, subjecting the uplift of cargo between Kuwait and Manila to the same revenue sharing arrangement as the uplift of passengers.^[13] From 1981 until when the present incidents arose in 1995, there seems to have been no serious disagreements relating to the contract.

In April of 1995, delegations from the Philippines and Kuwait (Philippine Panel and Kuwait Panel) met in Kuwait. The talks culminated in a Confidential Memorandum of Understanding (CMU) entered into in Kuwait on 12 April 1995. Among the members of the Philippine Panel were officials of the Civil Aeronautics Board (CAB), the Department of Foreign Affairs (DFA), and four officials of Philippine Airlines: namely its Vice-President for Marketing, Director for International Relations, Legal Counsel, and a Senior International Relations Specialist. Dr. Victor S. Linlingan, the Head of the Delegation and Executive Director of the CAB, signed the CMU in behalf of the Government of the Republic of the Philippines.

The present controversy stems from the fourth paragraph of the CMU, which read:

4. The two delegations agreed that the unilateral operation and the exercise of third and fourth freedom traffic rights shall not be subject to any royalty payment or commercial arrangements, as from the date of signing of this [CMU].

The aeronautical authorities of the two Contracting Parties will bless and encourage any cooperation between the two designated airlines.

The designated airlines shall enter into commercial arrangements for the unilateral exercise of fifth freedom traffic rights. Such arrangements will

be subject to the approval of the aeronautical authorities of both contracting parties.^[14]

On 15 May 1995, Philippine Airlines received a letter from Dawoud M. Al-Dawoud, the Deputy Marketing & Sales Director for International Affairs of Kuwait Airways, addressed to Ms. Socorro Gonzaga, the Director for International Relations of Philippine Airlines.^[15] Both Al-Dawoud and Gonzaga were members of their country's respective delegations that had met in Kuwait the previous month. The letter stated in part:

Regarding the [Kuwait Airways/Philippine Airlines] Commercial Agreement, pursuant to item 4 of the new MOU[,] we will advise our Finance Department that the Agreement concerning royalty for 3rd/4th freedom traffic will be terminated effective April 12, 1995. Although the royalty agreement will no longer be valid, we are very keen on seeing that [Philippine Airlines] continues to enjoy direct participation in the Kuwait/Philippines market through the Block Space Agreement and to that extent we would like to maintain the Jt. Venture (Block Space) Agreement, although with some minor modifications.^[16]

To this, Gonzaga replied to Kuwait Airways in behalf of Philippine Airlines in a letter dated 22 June 1995.^[17] Philippine Airlines called attention to Section 6.5 of the Commercial Agreement, which read:

This agreement may be terminated by either party by giving ninety (90) days notice in writing to the other party. However, any termination date must be the last day of any traffic period, e.g.[,] 31st March or 31st October.^[18]

Pursuant to this clause, Philippine Airlines acknowledged the 15 May 1995 letter as the requisite notice of termination. However, it also pointed out that the agreement could only be effectively terminated on 31 October 1995, or the last day of the then current traffic period. Thus, Philippine Airlines insisted that the provisions of the Commercial Agreement "shall continue to be enforced until such date."^[19]

Subsequently, Philippine Airlines insisted that Kuwait Airways pay it the principal sum of US\$1,092,690.00 as revenue for the uplift of passengers and cargo for the period 13 April 1995 until 28 October 1995.^[20] When Kuwait Airways refused to pay, Philippine Airlines filed a Complaint^[21] against the foreign airline with the Regional Trial Court (RTC) of Makati City, seeking the payment of the aforementioned sum with interest, attorney's fees, and costs of suit. In its Answer,^[22] Kuwait Airways invoked the CMU and argued that its obligations under the Commercial Agreement were terminated as of the effectivity date of the CMU, or on 12 April 1995. Philippine Airlines countered in its Reply that it was "not privy to the [CMU],"^[23] though it would eventually concede the existence of the CMU.^[24]

An exhaustive trial on the merits was had. On 25 October 2002, the RTC rendered a Decision in favor of Philippine Airlines. The RTC noted that "the only issue to resolve in this case is a legal one," particularly whether Philippine Airlines is entitled to the sums claimed under the terms of the Commercial Agreement. The RTC also considered as a corollary issue whether Kuwait Airways "validly terminated the

Commercial Agreement x x x, plaintiff's contention being that [Kuwait Airways] had not complied with the terms of termination provided for in the Commercial Agreement."

The bulk of the RTC's discussion centered on the Philippine Airlines' claim that the execution of the CMU could not prejudice its existing rights under the Commercial Agreement, and that the CMU could only be deemed effective only after 31 October 1995, the purported effectivity date of termination under the Commercial Agreement. The rationale for this position of Philippine Airlines was that the execution of the CMU could not divest its proprietary rights under the Commercial Agreement.

On this crucial point, the RTC agreed with Philippine Airlines. It asserted the obligatory force of contracts between contracting parties as the source of vested rights which may not be modified or impaired. After recasting Kuwait Airway's arguments on this point as being that "the Confidential Memorandum of Understanding is superior to the Commercial Agreement[,], the same having been supposedly executed by virtue of the state's sovereign power," the RTC rejected the argument, holding that "[t]he fact that the [CMU] may have been executed by a Philippine Panel consisting of representative [*sic*] of CAB, DFA, etc. does not necessarily give rise to the conclusion that the [CMU] is a superior contract[,], for the exercise of the State's sovereign power cannot be arbitrarily and indiscriminately utilized specifically to impair contractual vested rights."^[25]

Instead, the RTC held that "[t]he Commercial Agreement and its specific provisions on revenue sharing having been freely and voluntarily agreed upon by the affected parties x x x has the force of law between the parties and they are bound to the fulfillment of what has been expressly stipulated therein."^[26] Accordingly, "the provision of the [CMU] must be applied in such a manner that it does not impair the vested rights of the parties."

From this Decision, Kuwait Airways directly filed with this Court the present Petition for Review, raising pure questions of law. Kuwait Airways poses three questions of law for resolution: whether the designated air carrier of the Republic of the Philippines can have better rights than the government itself; whether the bilateral agreement between the Republic of the Philippines and the State of Kuwait is superior to the Commercial Agreement; and whether the enforcement of the CMU violates the non-impairment clause of the Constitution.

Let us review the factual backdrop to appreciate the underlying context behind the Commercial Agreement and the CMU. The Commercial Agreement was entered into in 1981 at a time when Philippine Airlines had not provided a route to Kuwait while Kuwait Airways had a route to Manila. The Commercial Agreement established a joint commercial arrangement whereby Philippine Airlines and Kuwait Airways were to jointly operate the Manila-Kuwait (and vice versa) route, utilizing the planes and services of Kuwait Airways. Based on the preambular paragraphs of the Joint Services Agreement, as of 1981, Kuwait Airways was interested in establishing a "second frequency" (or an increase of its Manila flights to two) and that "as a result of cordial and frank discussions the concept of a joint service emerged as the most desirable alternative option."^[27]

As a result, the revenue-sharing agreement was reached between the two airlines, an agreement which stood as an alternative to both carriers offering competing flights servicing the Manila-Kuwait route. An apparent concession though by Philippine Airlines was the preclusion of the exercise of one of the fundamental air traffic rights, the Fifth Freedom traffic rights with respect to the Manila-Bangkok-Kuwait, thereby precluding the deplaning of passengers from Manila in Bangkok and the boarding in Bangkok of passengers bound for Manila.

The CMU effectively sought to end the 1981 agreement between Philippine Airlines and Kuwait Airways, by precluding any commercial arrangements in the exercise of the Third and Fourth freedom traffic rights. As a result, both Kuwait and the Philippines had the respective right to board passengers from their respective countries and deplane them in the other country, without having to share any revenue or enter into any commercial arrangements to exercise such rights. In exchange, the designated airline or airlines of each country was entitled to operate six frequencies per week in each direction. In addition, the designated airlines were allowed to enter into commercial arrangements for the unilateral exercise of the Fifth Freedom traffic rights.

Another notable point, one not touched upon by the parties or the trial court. It is well known that at the time of the execution of the 1981 agreements, Philippine Airlines was controlled by the Philippine government, with the Government Service Insurance System (GSIS) holding the majority of shares. However, in 1992, Philippine Airlines was privatized, with a private consortium acquiring 67% of the shares of the carrier.^[28] Thus, at the time of the signing of the CMU, Philippine Airlines was a private corporation no longer controlled by the Government. This fact is significant. Had Philippine Airlines remained a government owned or controlled corporation at the time the CMU was executed in 1995, its status as such would have bound Philippine Airlines to the commitments made in the document by no less than the Philippine government. However, since Philippine Airlines had already become a private corporation at that juncture, the question of impairment of private rights may come into consideration.

In this regard, we observe that the RTC appears to have been under the impression that the CMU was brought about by machinations of the Philippine Panel and the Kuwait Panel of which Philippine Airlines was not aware or in which it had a part. This impression is not exactly borne by the record since no less than four of the nine members of the Philippine Panel were officials of Philippine Airlines. It should be noted though that one of these officials, Senior International Relations Specialist Arnel Vibar, testified for Philippine Airlines that the airline voiced its opposition to the withdrawal of the commercial agreements under the CMU even months before the signing of the CMU, but the objections were overruled.

Now, the arguments raised in the petition.

One line of argument raised by Kuwait Airways can be dismissed outright. Kuwait Airways points out that the third Whereas clause of the 1981 Commercial Agreement stated: "NOW, it is hereby agreed, subject to and without prejudice to any existing or future agreements between the Government Authorities of the Contracting Parties hereto ..." That clause, it is argued, evinces acknowledgement that from the beginning Philippine Airlines had known fully well that its rights under the Commercial Agreement would be limited by whatever agreements the Philippine