



The Legal Implications of Terminating a Construction Contract for the Parties Involved and Others.

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Abstract

The legal consequences of terminating a construction contract are particularly significant, especially regarding the contract itself and the resulting effects. This is because the contract stands as one of the principal sources of obligations that bind individuals in their transactions with others and serves as an effective means of achieving economic and social interests, provided these interests align with public order and moral standards. However, circumstances may arise where one party fails to fulfill its obligations, leading to the termination of the contract. The core issue addressed in this research centers on the breach committed by one party to the construction contract, particularly the contractor, who bears the primary obligation of executing the construction work. The importance of this study lies in its focus on a contract where the obligation pertains to continuous work, which represents the main commitment within the contract and through which the nature and reality of urban development are determined. This has led administrative bodies to intervene in the details of this work. The study aims to demonstrate that the law grants one or both contracting parties the right to disengage from the contractual bond by considering the nature of the contract entered into and duly ratified by the parties. The research plan comprises two sections: the first discusses the concept of termination, divided into two subsections—the first explaining the meaning and types of termination, and the second outlining the conditions for termination. The second section examines the consequences of contract termination, also divided into two subsections—the first analyzing the impact of terminating a construction contract on the contracting parties, and the second exploring its effect on third parties.

Keywords: Contract, Construction, Termination, Contracting Parties, Third Parties, Consequences.

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Introduction

1- Research Topic

When a contract is executed in accordance with the law, it is obligatory to fulfill the commitments contained within it. However, situations may arise where one party is unable to fulfill their obligations due to an

external cause or where the other party fails to perform their duties, placing them in a legally precarious position as their obligations remain in force under a valid contract. In such cases, the only recourse is to disengage from these obligations through a legally established right, which is the termination of the contract. The most prominent examples of contract termination are found in contracts related to work, and one of the most significant of these is the construction contract, where the work represents a fundamental obligation. Termination in this context signifies the dissolution of the contractual bond, whether by mutual agreement, litigation, or by operation of law. Therefore, the research will outline the importance, issues, methodology, and plan as detailed below:

2- Importance of the Research

The importance of this research lies in its focus on a contract where the obligation pertains to continuous work, which constitutes the primary commitment within the contract. This work determines the form and reality of urban development, prompting administrative authorities to intervene in the details of this work.

3- Research Problem

The central issue addressed in this research revolves around the breach committed by one party to the construction contract, particularly the contractor, who bears the greater responsibility, as it is through their work that the construction is completed.

4- Research Methodology

The researcher has employed an analytical approach in examining the concept of contract termination and its impact on the contracting parties and third parties within the context of Iraqi legislation. This analysis is supported by judicial decisions issued by the relevant courts.

5- Research Plan

To thoroughly explore the subject of the study, the research plan has been divided into two sections. The first section discusses the concept of termination, divided into two subsections—the first addressing the meaning and types of termination, and the second outlining the conditions for termination. The second section examines the consequences of terminating a construction contract, also divided into two subsections—the first analyzing the impact of contract termination on the contracting parties, and the second exploring its effects on third parties.

Section One: The Concept of Termination of a Construction Contract

The construction contract, like all other contracts, is founded on three essential pillars, which we shall not delve into within this research, as the study is strictly focused on the termination and its consequences. These pillars—consent, object, and cause—can be referred to under the general principles of obligations. Since a construction contract is based on the obligation to perform work, the most crucial pillar is the object. In the context of a construction contract, this pillar comprises two elements: the first being the employer's obligation to pay the agreed compensation, and the second being the contractor's obligation to complete the work. Many legal scholars argue that the object should be studied alongside the pillars of obligation rather than the pillars of the contract itself. They believe it is essential to distinguish between the object of the contract, which is the legal operation intended to be achieved by entering into the contract, and the object of the obligation, which is the performance that the debtor is committed to. The object of the obligation materializes in the execution of what the contracting parties agreed upon when the contract was formed, and it is always a task to be performed⁽¹⁾.

Therefore, in this section, we will discuss two aspects:

- The First Aspect will clarify the meaning and types of termination by defining it both linguistically and legally.

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- The Second Aspect will examine the procedural conditions for termination.

First Aspect: The Meaning and Types of Termination

To understand the meaning of termination, we will address its definition from both linguistic and legal perspectives in the first subsection, and then we will outline the various types of termination in the second subsection.

Subsection One: Definition of Termination

Termination in Language: Termination, in its linguistic sense, refers to the act of annulment. To "terminate" something means to nullify it, causing it to be void, or to end it⁽²⁾. The word "termination" also conveys the notion of separation, as when one dislocates a joint, or weakens and destroys something, such as a contract or decision. It can also imply discarding something, as in "terminating a garment," meaning to remove or discard it⁽³⁾.

Termination in Legal Terminology: The Iraqi legislator does not provide a specific definition of termination but addresses the general provisions for termination in Articles 177 to 180 of the Iraqi Civil Code. It also covers the specific provisions for terminating a construction contract in Articles 868, 869, and 885 of the same code. Additionally, the contract of construction is defined in Article 864, where it allows the employer to terminate the construction contract if the contractor delays starting the work or if there is such a significant delay in completing it that it becomes impossible to finish within the agreed-upon timeframe. Article 868 permits termination if the contractor is found to be executing the work defectively or contrary to the terms of the contract, after a warning to correct the approach, and the deadline passes without the necessary adjustments being made⁽⁴⁾.

Termination in Legal Doctrine: Legal scholars have offered various definitions of termination. Dr. Abdul Majid Al-Hakim defines it as "a defense against non-performance based on the idea of the interdependence of reciprocal obligations in synallagmatic contracts, where the nature of the contract requires that one party's obligation is linked to the other party's obligation. It is the final release from the obligations established under the contract⁽⁵⁾."

The Second Branch: Types of Rescission

The civil law jurists classify rescission into three types: rescission may occur through the judiciary, known as judicial rescission; through mutual agreement between the parties, known as consensual rescission; or by operation of law, known as automatic rescission. These will be detailed in the following three paragraphs:

1. **Judicial Rescission:** This is rescission achieved through a court ruling that dissolves the contractual bond. It is the general rule for rescission since disputes are typically adjudicated by the judiciary. The contractor is generally obligated to complete the work within the agreed timeframe, with their obligation being a commitment to the outcome rather than to a method. It is insufficient for the contractor to demonstrate mere diligence to be exempted from liability for delays. The employer, in case of the contractor's breach, may request rescission, which is subject to the court's discretionary authority⁽⁶⁾.

2. **Consensual Rescission:** This type occurs when the contract terminates upon the lapse of the specified period. If the contract includes a clause allowing either party to rescind before the deadline, such rescission is permissible. This right is valid and does not contravene public policy, as the principle allows for freedom from contractual commitments⁽⁷⁾. Parties may agree to rescind the contract upon one party's breach, which

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may be executed consensually rather than through litigation. However, consensual rescission is rare at this stage, with parties generally resorting to litigation unless it is agreed upon in advance at the contract's inception⁽⁸⁾.

3. Legal Rescission: According to the first paragraph of Article 179 of the Iraqi Civil Code, "If the subject of the contract is destroyed while in the possession of the owner, the contract is rescinded whether the destruction is due to the owner's actions or an external force, and the owner must return any consideration received to the other party." The provision addresses two scenarios of impossibility of performance, which should be distinguished: one due to the debtor's fault and the other due to an external cause. Only in the latter case does the contract dissolve and the debtor's obligation terminate without compensation⁽⁹⁾.

Second Requirement: Procedural Conditions for Rescission

These conditions rely on two essential elements, without which rescission cannot proceed: a formal notice to the breaching party and filing a lawsuit requesting rescission.

1. **NOTICE:** This is a legal act involving a formal procedure by which the creditor requests the debtor to fulfill their obligations or debt. The concept of notice revolves around formally recording the debtor's delay, placing them in default for their failure to perform. The notice presupposes a debtor who has not fulfilled their obligation, and its purpose is to establish that the debtor is in delay if they do not comply upon receiving the notice⁽¹⁰⁾.

Notice is required for two reasons: firstly, from a legal perspective, mere delay in performance does not suffice to deem the debtor in default. The expiration of the due date indicates the debt is due, and if the creditor does not demand performance, their silence implies tolerance and implicit consent after the due date. To refute this presumption, the creditor must express a renewed desire to assert their right within the due period and notify the debtor of their intolerance towards the delay. Secondly, from an ethical standpoint, notifying the debtor of their default and requesting performance is a measure required by moral values before surprising the debtor with actions that might affect their reputation⁽¹¹⁾.

Second:Filing a Lawsuit for Contract Rescission:

Article 2 of the Iraqi Civil Procedure Code defines a lawsuit as "a request by a person seeking their right from another before the judiciary." Article 3 of the same code stipulates that both parties to the lawsuit must possess the necessary legal capacity. In legal terminology, a lawsuit is the authority to resort to the judiciary to obtain or protect a right, as defined by Dr. Adnan Al-Khatib, who describes it as the right granted to every individual to approach the judicial authority to recover a frozen or usurped right. Thus, a lawsuit is a means provided by law for individuals, whether natural or legal persons, singular or plural, to assert their rights through the judiciary. According to Article 2 of the Civil Procedure Code, a lawsuit consists of three elements: a written request (oral requests are insufficient), a claim based on a legal right, and the submission of this request to the court. Consequently, requests made to administrative bodies do not fall within the definition of a lawsuit, even if they include the first two elements⁽¹²⁾.

Moreover, if the employer is a government entity, they are entitled to enforce the contract at the contractor's expense after withdrawing the work in accordance with the Government Contracts Implementation Instructions No. 2 of 2014 and the General Conditions for Civil Engineering Contracts. Thus, filing a lawsuit for rescission is not the only option available to the creditor; these options are rights established by the applicable laws⁽¹³⁾.

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Chapter Two: Effects of Rescinding a Construction Contract

As a general rule, rescinding a contract results in the dissolution of the contract and the nullification of its effects retroactively, thereby eliminating obligations that had arisen prior to the rescission. Following rescission, the contract is considered non-existent from a legal perspective for both the contracting parties and third parties, reverting each party to their pre-contractual state, as the contractual relationship no longer exists to be relied upon by either creditor or debtor. This dissolution is an inevitable consequence from the date of contract rescission⁽¹⁴⁾. Consequently, the effects of rescission will be examined first in relation to the contracting parties and second concerning third parties not involved in the contract.

First Section: Effects of Rescinding a Construction Contract on the Contracting Parties

The Iraqi legislator has not explicitly stated whether rescission has immediate or retroactive effects from its inception, either within the general provisions of rescission or the specific provisions related to construction contracts. However, some civil law scholars have addressed this issue and differed on the implications concerning the contract's termination, liability upon rescission, and entitlement to compensation resulting from rescission. These issues will be discussed in the following three paragraphs:

1. Effect of Contract Termination: It is known that the theory of contract rescission applies to all bilateral contracts, which may be ongoing or of other types. While legal scholars generally agree that this theory is applicable to all such contracts, they disagree on the retroactive effect of rescission. This disagreement can be attributed to two views: the first holds that rescission of term contracts does not have retroactive effects, and thus obligations arising from the past are not nullified; its effect is limited to ending the contractual relationship for the future. The second view maintains that the retroactive effect of rescission is uniform across all cases and should apply to all contracts without distinction⁽¹⁵⁾.

It is noteworthy that the Iraqi legislator did not use the phrase "restoring the situation to what it was" when discussing contract rescission or automatic rescission. Instead, Article 180 of the Civil Code states: "If a contract for the exchange of financial assets is rescinded or automatically rescinded, the obligation arising from it ceases, and the substitute due under the contract does not need to be delivered. If it has been delivered, it should be returned; if return is impossible, compensation should be determined." The legislator avoided using the phrase "restoring the situation" and preferred the term "if return is impossible," suggesting that in some contracts, it is impossible to restore the situation to what it was before the contract. In this regard, the Federal Court of Appeal of Dhi Qar ruled in one of its decisions that rescission of a lease contract did not affect the executed portion of the contract for the period preceding the rescission and that the rescission was effective from the date of the court's decision⁽¹⁶⁾. This decision was confirmed by the Federal Court of Cassation⁽¹⁷⁾.

2: Determining Liability for Losses Between Contracting Parties

In bilateral contracts, as a general rule, rescission is permissible if one party fails to perform their obligation, even if the failure is due to a force majeure. According to the theory of rescission, the liability shifts from the creditor to the debtor in bilateral contracts. This is because, if the debtor is unable to fulfill their obligation, the creditor may request rescission of the contract instead of bearing the consequence of impossibility, thus relieving the creditor of the obligation and transferring the burden to the debtor⁽¹⁸⁾.

If the subject of the contract is destroyed before delivery to the employer due to an unforeseen event not caused by either party, the loss or damage is the contractor's responsibility. The contractor cannot claim payment for their work or seek reimbursement for expenses incurred unless they had previously issued a notice to the employer requesting the delivery of the completed work (Article 887/1 of the Iraqi Civil Code).

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If the destruction of the work material is due to an unforeseen event, responsibility falls on the supplier, whether the contractor or the employer. If the destruction or damage results from the employer's fault, the contractor is entitled to full payment despite the destruction and may seek compensation for damages under Article 887, paragraph 4 of the Civil Code, which states, "If the destruction or defect of the subject is due to the fault of the employer or a defect in the supplied material, the contractor is entitled to payment and compensation, if applicable." The employer alone bears the loss if they were requested to accept the item and refused. If the item is destroyed or damaged, the employer is responsible and the contractor does not bear any loss. Conversely, if the item is destroyed or damaged due to the contractor's fault, the contractor is liable for the loss and must compensate the employer for the value of the item supplied, while the employer is relieved of the obligation to pay the contractor. If the employer requests the contractor to deliver the item and the contractor refuses, and if the item is destroyed or damaged after the notice, the contractor bears the loss according to Article 887, paragraph 3 of the Iraqi Civil Code⁽¹⁹⁾.

3: Determining Who is Entitled to Compensation

Compensation is the consequence of rescission and is a remedy for breach. The Iraqi Civil Code permits the employer to rescind the contract unilaterally and halt the work, thereby terminating the construction contract if the work has not been completed. This right is granted to the employer even if the contractor has not commenced work. The employer may dissolve the contract from the date of its conclusion. Article 885 of the Civil Code clarifies that rescission by the employer is valid provided they compensate the contractor for expenses incurred. If the contractor has completed part of the work, such as constructing part of a building, the employer must compensate the contractor for the expenses incurred. Additionally, the contractor is entitled to compensation for the profit they would have earned had the contract been completed⁽²⁰⁾.

There are two scenarios to consider: First, if rescission occurs before the commencement of the work, the contractor is entitled only to compensation for lost profit, as they have not incurred work expenses or labor costs. Second, if rescission occurs after the contractor has begun and partially completed the work, such as laying the foundation or using materials and incurring transportation and labor costs, the contractor may claim compensation not only for lost profit but also for the costs of materials and labor used. Other instances of rescission allowed by the legislator under Articles 868 and 869 do not specify compensation since rescission in these cases results from a breach of contract terms rather than unilateral will. Therefore, while the specific provisions of the construction contract might not explicitly mention compensation, it remains valid based on the general rules of rescission according to Article 177 of the Iraqi Civil Code. The question arises whether a claim for compensation must be accompanied by a claim for rescission or if it can be pursued independently. Article 177/1 of the Civil Code allows for compensation if justified, stating that the claim for rescission may include compensation if warranted. However, the Federal Court of Cassation has ruled that compensation is a consequence of rescission and cannot be claimed separately from rescission. For instance, one decision stated, "Compensation is a consequence of rescission and must be claimed alongside rescission, requiring the dismissal of the claim in this regard⁽²¹⁾." Another decision noted, "The claimant is not entitled to claim payment for completed work if the contract has not been rescinded and the work has not been accepted⁽²²⁾."

Regarding delay penalties stipulated in Article 172/1 of the Civil Code, these are not a consequence of rescission but rather a result of the debtor's delay in fulfilling their contractual obligations. Thus, penalties are not applicable to unexecuted contracts since such penalties are for delays in performance, not non-performance, which is penalized by rescission. The Federal Court of Cassation has ruled that "the claimant is not entitled to delay penalties as the contract between the parties was not executed⁽²³⁾." Another decision

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stated, “The claimant cannot claim delay penalties under Clause 9 of the supply contract as penalties are imposed for delays in delivering the goods under the contract⁽²⁴⁾.” Therefore, the claimant is not entitled to delay penalties if the contract is not executed and may seek rescission through a lawsuit and claim compensation for any damages and lost profit.

Subsection Two ; Effects of Rescission of Construction Contracts on Third Parties

The general rule of the theory of rescission is that the retroactive effect of rescinding a contract extends beyond the cancellation of the contract and the obligations arising from it for the contracting parties, impacting all involved⁽²⁵⁾. Consequently, any third party who acquired a right from one of the contracting parties related to the subject of the rescinded contract will see their rights disappear in accordance with the dissolution of the obligations and rights of the party they dealt with as a result of the rescission⁽²⁶⁾.

While rescission results in the retroactive cancellation of the contract and the associated rights and obligations, affecting both the parties and third parties according to general principles, the purpose of the rescission theory in all its forms and applications is to protect the creditor and strengthen their legal position against a debtor who has failed to fulfill their contractual obligations. However, there are legal rules and logical considerations that can disrupt these principles. Therefore, it is sometimes necessary to set aside these rules in favor of stability in transactions and to ensure the importance of good faith in dealings⁽²⁷⁾).

Civil law scholars point out these considerations, including:

Property Rights Acquired by Third Parties in Good Faith Such as those who acquire rights to movable property or those who have acquired a right to immovable property that has been officially registered in the land registry. Official Mortgage: Rights accrued from an official mortgage.

Rights Acquired Under Proper Management Contracts: Rights gained through good management contracts. Rights Acquired by Prescription: Rights obtained through the process of prescription⁽²⁸⁾.

For contracts that involve ongoing performance, rescission cannot have retroactive effect back to the contract's inception because time is a fundamental element in these contracts. Consequently, the effects of these contracts remain in place, with the payment due for past performance remaining classified as such⁽²⁹⁾).

Thus, a construction contract does not retroactively dissolve to its inception but rather has an immediate effect from the date of rescission. Consequently, rights that have accrued to third parties from completed work remain intact because the rescission affects future obligations rather than completed work. For example, if a contractor has a garnishment order against a sum due for work already completed, the garnishment remains valid as the rescission does not affect the payment for work already performed.

Regarding subcontractors, who are considered third parties relative to the employer but have their own contract with the main contractor, the rescission of the primary construction contract does not automatically extend to the subcontractor's contract. The main contractor and the subcontractor have a separate contractual relationship, and rescission of the primary contract does not directly affect the subcontractor's agreement⁽³⁰⁾.

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Conclusion

The study of "Legal Effects of Rescinding Construction Contracts on Contracting Parties and Third Parties" was conducted based on the provisions of the Iraqi Civil Code No. 40 of 1951 (as amended), the General Conditions for Civil Engineering Works, Government Contracts Implementation Instructions No. 2 of 2014 and its accompanying regulations, as well as decisions from the Federal Court of Cassation. The research yielded several findings and recommendations as follows:

Findings:

1. In construction contracts where the administration is a party, the employer has multiple options for terminating the contractual relationship with the contractor. These include execution at the contractor's expense under Article 250 of the Civil Code and Government Contracts Implementation Instructions No. 1 of 2008, rescission under the aforementioned articles, or withdrawing from the work according to the General Conditions for Contracts and Government Contracts Implementation Instructions No. 2 of 2014 (amended).
2. The court has broad discretionary powers regarding rescission and can evaluate the presence of breach based on the amount of work completed and its compliance with contract specifications.
3. If the destruction or damage to the construction results from a defect in design or plans rather than execution, the engineer responsible for the design is liable. However, if the contractor knew of the design defect but continued work, the contractor and the engineer are jointly liable to the employer.
4. Compensation is assessed by experts as it involves technical matters, and the court has discretion to accept or prefer one expert's opinion over another.

Recommendations:

1. The Iraqi legislator permits the employer to rescind a construction contract under specific conditions, such as delays (Article 868) and defective performance (Article 869), and allows unilateral termination even if the contractor has not breached the contract (Article 885). However, these provisions do not grant the contractor the right to request rescission, implying that the contractor is solely bound by the contract while neglecting potential breaches by the employer. It is recommended to explicitly include the contractor's right to request rescission in the specific provisions for construction contracts.
2. Construction contracts involving administrative bodies often contain terms that favor these entities, such as compliance with the General Conditions for Contracts or Government Contracts Implementation Instructions. This may constitute an abuse of the contractor's rights under Article 177/1 of the Civil Code. It is advisable to amend Article 65 of the conditions to include a provision allowing challenges to withdrawal decisions before the competent court.
3. The activation of Article 177/1 of the Civil Code concerning deadlines is necessary. The article stipulates that "the court may grant the debtor a deadline." The provision should be applied in a comprehensive manner, considering the entirety of the obligation if the debtor has fulfilled part of it relative to the whole obligation.

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