RECENT DEVELOPMENTS

*Schlumberger Technology Corp. v. United States**

I. INTRODUCTION

As the frequency and volume of international trade increases to historic proportions,[1] so does the possibility of conflict between parties involved in international transactions. The logical relationship between an increase in trade and a concomitant increase in trade disputes has led to a continuous search for more effective ways to resolve private international disputes, and it has influenced the development of much of current international trade law.[2] Throughout the years, parties to international transactions have responded to the need to resolve disputes efficiently by developing comprehensive dispute resolutions systems.[3]

Meanwhile, individual countries and multinational organizations have attempted to complement private dispute resolution systems with international treaty law that encourages efficient dispute settlement. One such treaty is the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention (the "New York Convention").[4] By making valid foreign arbitral

---

* 195 F.3d 216 (5th Cir. 1999)

[1] For example, the combined value of goods imported into and exported from the United States alone has risen from $106.9 billion in 1972 to $1.72 trillion in 1999—an increase of nearly 1,600%. *See International Trade Admin., U.S. Dep't of Commerce, U.S. Trade in Goods, 1972–1999* (visited March 28, 2000) <http://www.ita.doc.gov/td/industry/otea/usfth/aggregate/H99t03.txt>.

[2] *See* Malcolm R. Wilkey, *Introduction to Dispute Settlement in International Trade and Foreign Direct Investment*, 26 LAW & POL'Y INT'L BUS. 613, 613 (1995) (noting that the "explosion" in the use of alternative dispute resolution (ADR) in the international sphere is "an inevitable result of [an] increase in trade").

[3] Indeed, private ADR methods such as arbitration have been used by parties for centuries as an impartial and authoritative resource for resolving trading disputes. *See, e.g.*, Michael Hoellering, *Alternative Dispute Resolution and International Trade*, 14 N.Y.U. REV. L. & SOC. CHANGE 785, 785 (1986). In particular, arbitration has proven to be helpful in resolving disputes in cases for which there is no other impartial forum available. *See* Michael Hoellering, *World Trade: To Arbitrate or Mediate—That Is the Question*, DISP. RESOL. J., Mar. 1994, at 67, 67. For an analysis of the advantages and disadvantages of international arbitration, see *id.*

[4] *See* Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38 [hereinafter New York Convention]. The United States acceded to the New York Convention in 1970 with the passage of the 1970 Federal Arbitration Act, 9 U.S.C. §§ 1–16 (1994), and the Convention is codified in Title 9 of the United States Code. *See* 9 U.S.C. §§ 201–208 (1994).

awards enforceable in the domestic legal systems of all of its signatories,[5] the New York Convention was an important step in international alternative dispute resolution (ADR), and it significantly increased the attractiveness of arbitration as a means of settling international disputes.[6]

Despite the development of institutions and legal norms such as the New York Convention to help resolve international commercial disputes, the legal environment in which a business must operate remains somewhat precarious. Increased trade and trade-related disputes often create unique problems for participants in international transactions, who many times must venture into unchartered legal waters. Additionally, the domestic legal systems that are called to resolve issues associated with international trade are often faced with situations involving the complex interaction of domestic and international laws. In many instances, the domestic legal system that a court must use as a backdrop to resolve an issue is ill-suited to deal with particular legal problems. Quite simply, the law in many cases does not anticipate several of the situations courts are now called on to address.

Fortunately, domestic legal systems increasingly are developing coherent law to address international transactions and the legal issues attendant to them.[7] Additionally, domestic legal systems are becoming more adept at applying national law to situations that arise from international transactions. *Schlumberger Technology Corp. v. United States*[8] is one example of a domestic court effectively applying domestic law to a situation born from an international transaction and a dispute that resulted from it. The result of this effort is that domestic tax law is made clearer, and a hallmark of international dispute settlement, arbitration, is made slightly more attractive to American corporations.

---

[5] Article III of the Convention provides in pertinent part that "[e]ach Contracting State shall recognize arbitral awards as binding and enforce them . . . . There shall not be imposed substantially more onerous conditions or higher fees or charges on the recognition and enforcement of arbitral awards . . . ." New York Convention art. III, *supra* note 4, 21 U.S.T. at 2519, 330 U.N.T.S. at 40.

[6] *See* Jessica Thorpe, *A Question of Intent: Choice of Law and the International Arbitration Agreement*, DISP. RESOL. J., Nov. 1999, at 17, 21.

[7] *See, e.g.*, Jonathan Charney, *Third Party Dispute Settlement and International Law*, COLUM. J. TRANSNAT'L L. 65, 67 (1997) ("International tribunals do provide valuable interpretations of international law, but it is the states that play the predominant role in creating and modifying its norms.").

[8] 195 F.3d 216 (5th Cir. 1999).

II. FACTS AND PROCEDURAL HISTORY

The facts in *Schlumberger* involve a complex series of transactions and legal proceedings that culminate in a dispute between an American corporation and the Internal Revenue Service. For convenience and clarity, this Note first discusses the underlying international transaction that gave rise to the eventual tax dispute. It then addresses the circumstances that directly led up to the tax dispute involved in the case.

A. *The Underlying Dispute*

In 1966, Sedco, Inc. (Sedco), a Texas Corporation, entered into a joint venture agreement with Sonatrach, a company entirely owned by the Algerian government.[9] According to the terms of the joint venture agreement, the two companies formed a third company to explore oil and gas deposits.[10] Sedco owned a forty-nine percent interest in newly formed company, and Sonatrach retained a fifty-one percent majority interest.[11] The joint venture agreement also required that all disputes between the parties be submitted to binding arbitration before a Swiss tribunal.[12]

In 1981, Sedco claimed that Sonatrach was using its majority power in the exploration company to deprive Sedco of the value of its stock in the venture.[13] Pursuant to the joint venture agreement, Sedco submitted its claims to a Swiss tribunal in February 1981.[14] Shortly after Sedco submitted the matter to arbitration, Sonatrach began liquidating the exploration venture.[15] At this point, the conflict intensified as Sonatrach claimed that Sedco was entitled only to receive $2.6 million from the liquidation of the company's assets.[16] Sedco disputed this sum, referred to by the United States District Court for the Southern District Court of Texas as the "Stated

---

[9] *See id.* at 217. "Sonatrach" is an abbreviated name for the Société Nationale de Transport et de Commercialisation des Hydrocarbons. *See* Schlumberger Tech. Corp. v. United States, No. CIV. A. H-96-0259, 1998 WL 919867, at *2 (S.D. Tex. 1998).

[10] *See Schlumberger*, 195 F.3d at 217.

[11] *See id.*

[12] *See id.*

[13] *See id.*

[14] *See id.*; *see also Schlumberger*, 1998 WL 919867, at *2.

[15] *See Schlumberger*, 1998 WL 919867, at *2.

[16] *See Schlumberger*, 195 F.3d at 217. The record indicates that Sonatrach refused to pay this so-called "Stated Liquidation Amount" despite Sedco's repeated requests. *See Schlumberger*, 1998 WL 919867, at *2.

Liquidation Amount,"[17] and submitted the additional matter of liquidation compensation to the tribunal.[18]

In February 1984, the Swiss tribunal rendered a decision in favor of Sedco and ordered that Sonatrach pay Sedco approximately $26 million.[19] Sonatrach subsequently appealed the arbitral decision to a Swiss appellate court, which granted a temporary stay of the award in April of 1984.[20] In May and June of 1994, the Swiss appellate court revoked the stay and rejected Sonatrach's request that the award be nullified, respectively.[21]

On September 7, 1984, with the Swiss arbitral panel's decision in hand, Sedo sought to enforce the award in the French Tribunal de Grand Instance.[22] Sedco chose France as a suitable place to enforce the arbitral award because Sonatrach owned significant assets in the country that could be attached to enforce Sonatrach's obligation.[23] Pursuant to its domestic legal procedures, the French Tribunal granted Sedco an enforcement order, called an *exequatur* in French, on September 19, 1984. [24] The *exequatur* was provisional to the extent that it was subject to specific recognized defenses[25] that Sonatrach could assert by requesting an appeal within three months of its notification that the *exequatur* was granted.[26]

In October 1994, Sedco requested and was granted the right to begin attachment proceedings against Sonatrach's French assets.[27] According to French procedures, attachment, called *saisie-arrêt*, is carried out in two distinct phases.[28] In stage one, a garnishor—in this case Sedco—attaches assets held by domestic garnishees.[29] In stage two, which is analogous to the American process of execution on assets, the garnishor seeks to have its

---

[17] *See Schlumberger*, 1998 WL 919867, at *7.

[18] *See Schlumberger*, 195 F.3d at 217.

[19] *See id.* at 217.

[20] *See id.*

[21] *See id.*

[22] *See Schlumberger*, 1998 WL 919867, at *3.

[23] *See Schlumberger*, 195 F.3d at 217. Prior to seeking enforcement of the decision in France, Sedco informed Sonatrach that the deadline for an appeal of the Swiss court's decision had expired and requested that Sonatrach voluntarily comply with the arbitral award. *See id.*

[24] *See id.* at 217.

[25] *See id.* at 217–18. For a discussion of these defenses, see *infra* notes 57–59 and accompanying text.

[26] *See Schlumberger*, 195 F.3d at 218.

[27] *See id.*

[28] *See id.*

[29] *See id.* In this case, the garnishee was Gaz de France, which had at its disposal enough of Sonatrach's assets to satisfy the arbitral award. *See id.*

attachment validated by the appropriate French court, which then will direct the garnishee to pay to the garnishor the assets attached.[30] The second phase is contingent upon a lapse of the time in which to appeal the *exequatur* and an actual affirmation of the *exequatur* order.[31]

On December 11, 1984,[32] before the *saisie-arrêt* proceedings had concluded, Sedco and Sonatrach reached a tentative compromise agreement.[33] The agreement then was sent to the Algerian authorities for approval, and a settlement was finalized in 1985.[34]

B. *Dispute over the Recognition of Taxable Income*

Although rooted in the above transaction, the operative facts of *Schlumberger* begin on December 24, 1984, when Sedco merged into Schlumberger Technology Corporation (Schlumberger).[35] As a result of the merger, Sedco's final fiscal year for tax purposes ended on December 24, 1984.[36] When it filed its final income tax return, Sedco failed to include the $26 million Swiss arbitral award in its computation of taxable income.[37] Following a 1989 audit, the Internal Revenue Service (the "Service") issued a report in which it stated that, as a result of failing to include the arbitral award in its 1984 consolidated return, Sedco underreported its gross income by $27,175,581.[38] As a result of this alleged error, the Service imposed a tax deficiency and a substantial penalty for understatement of income.[39] Sedco

---

[30] *See id.*

[31] *See id.* Of course, an appeal of an *exequatur* can be denied explicitly and immediately, in which case a garnishor need not wait until the time for appeal has elapsed. *See id.*

[32] There is a discrepancy in the record regarding when the parties actually reached a tentative settlement agreement. The district court opinion states that the agreement was reached on December, 14, 1984, *see Schlumberger*, 1998 WL 919867, at *4, while the Fifth Circuit's opinion states that the agreement came on December 11, 1984, *see Schlumberger*, 195 F.3d at 218.

[33] *See Schlumberger*, 195 F.3d at 218.

[34] *See Schlumberger*, 1998 WL 919867, at *4. Sonatrach began making payments on the settlement agreement to Sedco on April 1, 1985. *See id.*

[35] *See id.*

[36] *See id.*

[37] *See id.*

[38] *See id.* According to the Service, Sedco failed to report the following amounts in gross income: $24,382,332 in capital gain income, $1,996,408 in interest income, and $796,841 in ordinary income. *See id.*

[39] *See id.* The tax deficiency is not stated in the record, but the understatement penalty assessed was $1,363,082.

(or Schlumberger as it was known after the merger) timely paid the deficiency and penalty, and it initiated the principal suit in the United States District Court for the Southern District of Texas to seek a refund of all taxes and penalties paid as a result of the 1989 audit report.[40]

In the district court, Schlumberger moved for partial summary judgment on the issue of its liability for the payment of additional taxes and penalties.[41] The Service likewise submitted a cross-motion for summary judgment on the issue of liability.[42] Upon entertaining both parties' motions, the district court granted Schlumberger's motion and held that it was not required to report as taxable income the arbitral award.[43]

On appeal, the United States of Appeals for the Fifth Circuit affirmed the district court opinion for the reasons set forth below in Part III of this Note.[44]

III. THE FIFTH CIRCUIT'S ANALYSIS

The Fifth Circuit's opinion is based on accepted American tax principles. Nonetheless, the particular facts of this case required the court to assess the effects of international law. Namely, the court was required to determine whether a foreign arbitral award, the enforcement of which was sought in a country that has signed the New York Convention, created income in an American beneficiary of the award when the beneficiary uses the accrual method of tax accounting.

This Part of the Note first will examine the accrual method of tax accounting as it comes to bear in the *Schlumberger* opinion. It then will discuss the New York Convention and its implications on the realization of income under American tax law.

A. *The Accrual Method of Tax Accounting and the "All Events Test"*

The parties in *Schlumberger* appeared to be in agreement over the nature of the tax law that was applicable in the case. Indeed, as the Fifth Circuit

---

[40] *See id.*

[41] *See id.* at *1.

[42] *See id.*

[43] *See id.* at *8. The district court also held that Schlumberger was not required to report as income the $2.6 million figure (the "Stated Liquidation Amount") Sonatarch originally offered Sedco when the former liquidated the exploration venture in 1981. *See id.* at *7.

[44] *See* Schlumberger Tech. Corp. v. United States, 195 F.3d 216, 219–21 (5th Cir. 1999). The circuit court does not seem to have addressed the issue of whether the "Stated Liquidation Amount" was includable as gross income in Sedco's 1984 return. *See id.*

noted, "[t]he law in this case is easy to state."[45] Under the well accepted "all events test," an accrual method taxpayer[46] such as Schlumberger is required to report income "in the taxable year in which the last event occurs which *unconditionally* fixes the right to receive income and there is a reasonable expectancy that the right will be converted to money."[47]

Furthermore, the court noted, both the Service and Schlumberger accepted the proposition that domestic American judgments constitute a fixed right to receive income for accrual method purposes despite the availability of collateral attack by the potential obligor of the judgment.[48] Nonetheless, for the reasons discussed below, the court found that foreign arbitral awards were sufficiently distinguishable from domestic judgments to cause the all events test to fail in cases in which a final, valid, and enforceable arbitral decision has been rendered.[49]

B. *Arbitral Awards and the New York Convention*

In *Schlumberger*, the Service argued that Sedco was required to include in gross income the amount of the arbitral award as soon as it received a final and unappealable judgment from the Swiss tribunal.[50] Specifically, by presenting expert testimony that there was no possible legal or factual basis for Sonatrach to contest Sedco's attachment of its French assets, the Service contended that the Swiss arbitral award unconditionally fixed Sedco's right to receive the full amount of the award.[51]

---

[45] *Id.* at 219.

[46] Under the Internal Revenue Code, taxpayers generally may choose the manner in which they report income received and outlays for which tax deductions are sought based on the normal business accounting method the firm uses. *See* I.R.C. § 446(a) (1994). The most common methods chosen by taxpayers are either the so-called cash method or the accrual method, both of which are permitted by I.R.C. § 446(c). Under the cash method, the taxpayer reports income when it is actually or constructively received. *See* Gordon T. Butler, *Economic Benefit: Formulating a Workable Theory of Income Recognition*, 27 SETON HALL L. REV. 70, 71 (1996). Although many taxpayers choose to use the cash method because of its simplicity, *see id.*, the Code limits the use of the cash method for many taxpayers. *See, e.g.*, I.R.C. § 448(a)(1) (1994) (forbidding the use of the cash method for all C corporations).

[47] *See Schlumberger*, 195 F.3d at 219 (emphasis added); *see also* Treas. Reg. § 1.451-1(a) (1994).

[48] *See Schlumberger*, 195 F.3d at 219.

[49] *See id.* at 221.

[50] *See id.* at 219.

[51] *See id.* at 218.

Schlumberger, on the other hand, argued that the all events test was not satisfied until it had a right to enforce the award in France by seizing Sonatrach's assets.[52] In other words, Schlumberger contended that income from the arbitral award did not accrue until the expiration of Sonatrach's right to appeal the French *exequatur* order.[53] Schlumberger supported its position by noting that the enforcement of the award could have been defeated if Sonatrach raised one of the defenses recognized by the New York Convention.[54]

The Fifth Circuit resolved this dispute by conducting a comparison of domestic judgments and foreign arbitral awards.[55] According to the court, there were three compelling differences between a domestic judgment and a foreign arbitral award that required that the receipt of the latter not be classified as satisfying the all events test.

First, the court noted that unlike a domestic judgment, an arbitral award must undergo a confirmation and enforcement procedure.[56] Such procedures are subject to the defenses provided for in the New York Convention.[57] In particular, the court noted that Article V of the Convention allows states to refuse to recognize or enforce foreign arbitral awards if the party against whom enforcement is sought proves that one of the following conditions applies: (1) the parties to the arbitration were in some way incapacitated, (2) the agreement to arbitrate is not valid under the laws of jurisdiction to which the parties have subjected themselves (i.e., it is illegal), (3) there was a lack of due process in the arbitration proceeding, (4) the award deals with matters

---

[52] *See id.* at 219.

[53] *See id.* The timing of the expiration of Sonatrach's right to appeal the *exequatur* order, namely three months after Sonatrach was notified of its issuance, *see supra* note 25 and accompanying text, was an important consideration in this case, as Sedco received notice that the order was granted on September 26, 1984 and merged with Schlumberger on December 24, 1984, *see Schlumberger*, 195 F.3d at 218.

Thus, the earliest possible deadline for Sonatrach's appeal—and the earliest date at which the all events test would have been met—was December 26, 1984, two days after Sedco's merger and the corresponding end to its tax year.

[54] *See id.* at 218–19. See *infra* notes 57–59 and accompanying text for a further discussion of defenses under the New York Convention.

[55] Although it is not clear from the record, the court's analysis indicates that the Service may have sought to draw an analogy between foreign arbitral awards and domestic judgments whose enforcement is sought in an American jurisdiction other than that which granted the award. By drawing this analogy, it appears that the Service attempted to bring foreign arbitral awards into the well-accepted legal position that domestic judgments are considered to satisfy the all events test. *See* discussion accompanying note 48, *supra*.

[56] *See Schlumberger*, 195 F.3d at 219–20.

[57] *See id.*

that are outside those contemplated in the agreement to arbitrate, (5) the composition of the arbitration panel was not in accordance with the agreement to arbitrate or the law controlling the arbitration, and (6) the arbitral award is not yet binding on the parties or has been suspended by a competent authority.[58]

Additionally, the court stated that the New York Convention subjected foreign arbitral awards to defenses based on the domestic law of the state in which enforcement is sought.[59] Specifically, the New York Convention allows a state to refuse to recognize an arbitral award if the dispute is not capable of settlement under the laws of the enforcing state or if enforcement of the award would violate the public policy of the enforcing state.[60] The court reasoned that these additional defenses separated foreign arbitral awards from domestic American judgments that, although subject to attack on collateral grounds, enjoy the benefit of the U.S. Constitution's full faith and credit clause and thus must be given the same effect as they would have in the state rendering the award regardless of any legal impediment.[61]

Secondly, the court noted that foreign arbitral awards are distinct from domestic judgments in that they are not self-executing but must instead be enforced through a separate *judicial* proceeding.[62] While recognizing that even domestic judgments sought to be enforced in the jurisdiction granting the award are not self-executing in the strict sense of the word, the court reasoned that the additional requirement of *judicial* confirmation—as opposed to automatic execution by nonjudicial means—created an additional enforcement step.[63] This additional step, the court continued, meant that it made "little sense to say a right to receive exists before the ability to execute on a judgment is granted."[64]

---

[58] *See id.* at 217; *see also* New York Convention art. V, *supra* note 4, 21 U.S.T. at 2520, 330 U.N.T.S. at 40, 42 (providing the full text of these defenses).

[59] *See Schlumberger*, 195 F.3d at 220.

[60] *See id.* at 217, 219–20; *see also* New York Convention art. V, *supra* note 4, 21 U.S.T. at 2520, 330 U.N.T.S. at 40, 42 (providing the full text of these defenses).

[61] *See Schlumberger*, 195 F.3d at 220.

[62] *See id.*

[63] *See id.*

[64] *Id.* While the court's analysis on this point is not particularly clear, it seems that it is attempting to say that unlike domestic judgments that may be enforced immediately after they are rendered, foreign arbitral awards are subject to judicial confirmation first, before the issue of enforceability even arises. Evidently, this additional step occurs when the court chooses to draw the line for purposes of deciding whether the all events test has been met. *See id.* at 221 ("Given that some line must be drawn, it makes sense to draw the line between a private arbitration award and a judicially enforceable order, even if the former flows almost always into the latter.").

Finally, and in the court's words, "most importantly", the court states that an arbitral award "has no legal effect without a stamp of judicial approval."[65] Thus, an arbitral award is uncertain and imparts no rights on the beneficiary until it receives the coercive power of a judicial proceeding.[66]

In concluding, the *Schlumberger* court refused to accept the Service's recommendation that it extend caselaw allowing the all events test to apply to expectations of payment that are legally unenforceable to the principal case.[67] According to the court, the cases cited by the Service to support its position[68] deal primarily with undisputed debts that were routinely paid despite the fact that they were legally unenforceable.[69] Consequently, the court instead decided to follow the general position that "taxpayers do not have to accrue disputed debts until the dispute is resolved."[70]

IV. CONCLUSION

It is worth noting that the *Schlumberger* decision appears to be one of first impression. As such, the decision has the obvious benefit of rendering the law more definite as it relates to the effect of international arbitration on American income tax law. This is no small matter when one considers that the plaintiff in this case, which most likely acted in good faith when failing to report the value of the arbitral award in its 1984 tax return, was faced with a significant tax liability.[71]

Additionally, the court's opinion adopts a commonsense position regarding the application of international arbitration principles to domestic tax law. In this fashion, the decision in *Schlumberger* also contributes in a relatively small way to the attractiveness of arbitration as a means for settling international disputes—at least as far as American companies are concerned.

---

[65] *Id.* at 220.

[66] *See id.* (quoting Michael H. Strub, Jr., Note, *Resisting Enforcement of Foreign Arbitral Awards Under Article V(1)(e) of the New York Convention: A Proposal for Effective Guidelines*, 68 TEX. L. REV. 1031, 1044 (1990)).

[67] *See id.*(citing Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982); Travis v. Commissioner, 406 F.2d 987 (6th Cir. 1969); Barker v. Macgruder, 95 F.2d 122 (D.C. Cir. 1938); Eastman Kodak Co. v. United States, 534 F.2d 252 (Ct. Cl. 1976)).

[68] See *id.* for a list of the cases presented by the Service to support its position.

[69] *See id.*

[70] *Id.* (citations omitted).

[71] In addition to the $1,363,082 understatement penalty imposed by the Service, Schlumberger likely faced a 35% tax on the alleged deficiency, which totaled $27,175,581. *See* I.R.C. § 11 (b)(1)(C) (1994) (assessing a 35% marginal tax rate on taxable income greater than $10,000,000).

If American companies using the accrual method know that they will not be taxed on arbitral awards until final enforcement proceedings have been taken, they may be less likely to postpone the initiation of arbitration as a way beneficially to structure their tax liability.

As international trade inevitably increases, there no doubt will continue to be more cases like *Schlumberger* in which domestic courts are called upon to clarify the effect of international law and legal principles to well-accepted domestic legal concepts. While this process will continue to be difficult and often will involve cases of first impression, it is a necessary step for the development of domestic law in the twenty-first century. Furthermore, the process is essential if businesses are to be able to operate in a legal climate that is relatively certain and free from costly mistakes lurking in shadows created by underdeveloped legal systems. In the end, decisions like *Schlumberger* are well worth the intellectual effort they require.

Craig M. Bryson