

Lockheed Martin Also Acquires Sikorsky's Legal Liabilities

Written by Nick Sanders
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At this point it's old news that United Technologies Corporation has sold its Sikorsky subsidiary to Lockheed Martin. The acquisition is generally held to be a "win" for LockMart, and reports state it will be immediately accretive to earnings. So: Good for Lockheed Martin. Also: Good for Sikorsky, which escapes a corporate parent that really didn't want it.

As is the case with any acquisition, the buyer doesn't just get the assets; it also gets the liabilities. Due diligence is the process of reviewing the acquisition target to make sure all liabilities – especially including any contingent liabilities – are identified and factored into the purchase price. Due diligence on government contracting targets is a bit different and more focused than "normal" due diligence, because the cost of defending (or settling) a contract non-compliance can change a good deal into a bad one. For example, if the target has weak controls over its estimating and pricing, the due diligence team is supposed to assess the potential for post-closing "defective pricing" allegations to surface. Similarly, if timekeeping controls are weak, the team is supposed to evaluate the possibility that systemic labor mischarging might be taking place. For a final example, an evaluation of the controls over identification and segregation of unallowable costs helps identify any potential legal issues in that area.

Presumably, when Lockheed Martin decided to acquire Sikorsky, it performed a rigorous due diligence and worked hard to identify any areas of potential non-compliance that might spark legal issues after the deal closed.

One issue – one contingent liability – that was already on the table months before the acquisition was the legal problem of Sikorsky's subsidiary, Sikorsky Support Services, Inc. (SSSI). SSSI was awarded a Navy contract in 2006 to provide support to the T-34 and T-44 turboprop training aircraft. In turn, SSSI issued a subcontract to another Sikorsky subsidiary, Derco Aerospace, to procure and manage the spare parts needed to provide that support. Derco billed SSSI its costs for doing so, plus overhead and profit. The U.S. Government objected to that arrangement, and filed suit in October, 2014.

As our readers know, accounting for inter-company costs (or inter-organizational transfers, as they're more formally called) between related parties under common control [is difficult](#), and companies don't always

[get it right](#)

. Normally, inter-organizational transfers are done at cost, excluding profit; but there are regulatory exceptions that permit transfers at price (including profit) under certain

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circumstances. We don't know whether Derco was entitled to an exception.

In this case, not only is the government alleging that SSSI misbilled its Navy customer, but that SSSI also submitted "false Certificates of Final Indirect Costs" in its annual proposals to establish final billing rates for years 2006 through 2012. The government has alleged "numerous claims for violations of the False Claims Act, for breach of contract and for unjust enrichment." The government seeks \$148 million in restitution for SSSI's alleged noncompliances.

For its part, Sikorsky stated (in its SEC filing) that "We believe that Derco was lawfully permitted to add profit and overhead to the cost of the parts, and maintain that SSSI did not submit any false certificates. We also believe that we have other substantial legal and factual defenses to the government's claims."

That being said, on July 13, 2015, or just a couple of weeks before the Lockheed Martin acquisition was announced, Sikorsky was informed that the Department of Justice had "opened a criminal investigation with respect this matter." There is a difference – a big difference – between civil and criminal allegations. The DoJ's subpoena definitely raised the stakes. Sikorsky was quick to note that it intends to "cooperate fully in the investigation."

We are obviously unclear on the details of the matter or what DoJ's motivation may have been for moving the matter from civil to criminal. However, we noted in [this WaPo story](#) that "the Justice Department also claims SSSI submitted false certificates for aircraft maintenance from 2006 to 2012." If true, those allegations might have been sufficient to get the criminal thing going. But we don't know.

We do wonder, though, if the continual series of investigations and allegations, and costs of providing legal defense for those investigations and allegations, played a role in UTC's decision to sell Sikorsky. UTC is a conglomerate that has huge purely commercial entities. Those entities have their own issues, of course; but they don't have the same level of regulatory oversight and extreme legal consequences that the government contracting entities do. Maybe the UTC Board of Directors got tired of dealing with the problems of one of its largest government contracting entities, and decided to sell the entity to the largest defense contractor in the world—one that presumably deals with such regulatory oversight and investigations and allegations on a daily basis.

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Thus: We wonder if the known contingent liabilities associated with this matter played a role in bringing the sales price down to a point where commenters think that Lockheed Martin got a very good deal, one that is immediately accretive to earnings.