

New SBA Regulation Would Encourage Venture Capital Investment in SBIR Grant Applicants ... Or Would It?

By Steven D. Tibbets

The U.S. Small Business Administration (SBA) issued a proposed rule on May 15, 2012 (the Proposed Rule),¹ that would increase opportunities for small businesses to obtain funding from venture capital firms while still participating in the Small Business Innovation Research (SBIR) program. In a departure from current requirements, the Proposed Rule would allow small businesses to be eligible for SBIR grants even when they have granted substantial ownership interests to venture capital firms. In theory, this change should encourage venture capital investment in current or prospective SBIR grantees. However, differences between affiliation principles for SBIR purposes and affiliation principles for general procurement purposes may inhibit venture capital firms' willingness to offer, and small businesses' willingness to accept, venture capital support.

SBIR Overview and Grantee Ownership Limitations

Under federal law, only businesses meeting particular size standards may receive benefits targeting small businesses, including SBIR grants and procurement contracts set aside for small businesses. Generally speaking, SBA defines "small businesses" as those with annual revenues or numbers of employees below certain ceilings that vary from industry to industry.² Under SBA regulations, companies related through a parent-subsidiary relationship, common ownership, a joint venture, or certain other ways are "affiliated" and considered to be one firm for purposes of determining size.³ Affiliation rules are designed to prevent what are effectively large businesses from maintaining numerous entities limited just enough in terms of revenue or headcount to be "small" and thus exploiting small business programs.

The SBIR program "is a highly competitive program that encourages small business[es] to explore their technological potential and provides the incentive to profit from its commercialization" through award of research and development grants.⁴ SBIR is a three-phase program. Phase I provides for awards of up to \$100,000 to support a six-month effort to explore the technical merit or feasibility of an idea or technology. Phase II awards can be up to \$750,000 to support two years of additional research and development work and evaluation of commercialization potential. Finally, in Phase III, grantees perform the work necessary to move an innovation "from the laboratory to the marketplace,"⁵ but Phase III grantees must obtain fund-



ing from private sector or non-SBIR government sources. For grant eligibility, companies must meet several criteria: (1) be "small" under applicable regulations; (2) be American-owned and independently operated; (3) be for-profit; (4) employ the principal researcher on the project; and (5) have no more than 500 employees.

Additionally, strict ownership limitations apply to prospective SBIR grantees. SBIR grantees must: (1) be 51% owned or controlled by one or more U.S. citizens; (2) be 51% owned and controlled by a firm that is, itself, 51% owned or controlled by U.S. citizens; or (3) be a joint venture in which each venture meets one of the two foregoing criteria.⁶ These criteria are applied literally—it is not sufficient that the ultimate parent of an SBIR grantee is owned by U.S. citizens; the immediate parent must qualify.⁷

Many businesses owned by, and therefore affiliated with, venture capital firms have been excluded from SBIR eligibility as these limitations make it difficult, if not impos-

sible, for small businesses to raise capital to achieve SBIR program objectives from venture capital firms. In other words, small businesses have effectively been forced to choose between funding from the government or funding from venture capital firms. This inherent conflict has resulted in industry criticism⁸ regarding small businesses' ability to achieve the ultimate innovative program objectives for which the SBIR was created. The Proposed Rule's intention is to align these interests.

SBA's Proposed Rule on Venture Capital Ownership

The 2012 National Defense Authorization Act (NDAA) became law on Dec. 31, 2011. Section 5107 of the NDAA expands SBIR eligibility to encourage firms "owned in majority part by multiple venture capital operating companies, hedge funds, or private equity firms" to invest in SBIR grantees, and establishes a preference that Phase III awards by agencies other than SBA be made to grantees that "developed the technology."⁹

The Proposed Rule implements the NDAA by providing rules governing SBIR eligibility for businesses in which venture capital firms may have equity stakes. Specifically, an SBIR grantee can be "a concern which is more than 50% owned by multiple domestic business concerns that are venture capital operating companies, hedge funds, private equity firms, or any combination of these domestic business concerns," although "no single venture capital operating company, hedge fund, or private equity firm may own more than 50%" of the grantee. These financial companies must be "domestic business concerns," which means they are organized in the United States, maintain a U.S. place of business, operate primarily in the United States, and pay U.S. taxes. They must also meet the definition of "venture capital operating company," "hedge fund" or "private equity firm" set out elsewhere in SBA's regulations. In addition, the headcount limitation still applies, that is, the SBIR applicant and its affiliates cannot together employ more than 500 people.¹⁰

The Proposed Rule contains detailed provisions regarding when affiliation—the ability of one entity to control another or the ability of a third party to control both—arises. The bases for SBIR affiliation in the Proposed Rule are basically the same as those for affiliation under government procurement and other small business programs, with one important exception: affiliation with a portfolio company is not established "solely on the basis of one or more shared investors."¹¹ In other words, a small business in which two or more domestic financial firms have a stake is not "large" by virtue of company headcounts in those financial firms' portfolios. This is a departure from government procurement size standards, which make no such exceptions for these portfolio companies and, more or less, provide that all members of a parent firm's overall corporate family are "affiliates."¹² Thus, a firm may be small for SBIR purposes, but not small for general procurement purposes when affiliated with its venture capital firm owners. While the SBIR program defines size in terms of the 500 employees ceiling, size for procurement purposes may be defined as headcount or annual revenues, the latter

ranging from \$750,000 to more than \$30 million depending on the relevant industry classification. Many venture capital firms will likely push revenues of the small businesses they back over the applicable size standard if they are found to be affiliated for procurement purposes.

Implications for Venture Capital Firms and the Small Businesses They Own and Support

The title of this piece is phrased as a question, asking whether the Proposed Rule will encourage venture capital investment in these grant applicant companies. The answer is, "probably." After all, the Proposed Rule and the underlying statute expressly allow venture capital firms to have significant ownership stakes in SBIR grantees for the first time. And for many applicants, the story ends there. Many SBIR grants support development of products or technology for primarily commercial applications or they relate to technology so specialized that only the grantee is able to perform any follow-on research grants or procurement contracts.

For other grantees, however, affiliation with their venture capital owners can be fatal to a long-term research and development effort's profitability or the grantee's existence. This occurs where an SBIR grantee develops technology uniquely suited to address a government need and for which there is no private-sector market. Federal laws require government agencies to maximize competition for all procurements, but also favor restriction of procurements to small businesses when certain criteria are met.¹³ Where an SBIR grantee has developed a technology the government values, the grantee faces less competition in contracts for deliverables containing or using that technology if it maintains its small business status for procurement purposes. Therefore, venture capital firms should, at a minimum, consider the grantee's ability to maintain its "small" status (by the non-SBIR small business definition) and the accompanying reduced competition as its technology matures and is converted into useful products for government purchase.

In addition, prospective SBIR grantees' inability to remain small for general, non-SBIR purposes due to an affiliated venture capital firm's annual revenues could negatively affect the firm's willingness to invest in the grantee in the first place. Relatedly, a grantee may decide the possibility of losing small business status is not worth seeking venture capital backing—particularly where providing other products and services to the government is an additional line of business providing steady income for the small business. If a small business wishes to pursue government contracting opportunities unrelated to the SBIR grant, its small status could be a significant boon to the small business' prospects that acceptance of venture capital backing might jeopardize. Thus, the distinction between affiliation for SBIR purposes and affiliation for procurement purposes may actually have a chilling effect on the goal of increased venture capital investment in prospective SBIR grantees. Consequently, small businesses will be forced to evaluate their unique business mix with the government to determine whether accepting venture

capital is worth risking their small status for future procurements. While the intention of the SBA's Proposed Rule is to encourage innovation by small businesses, it may not resolve the issue that keeps small businesses from seeking or accepting venture capital backing.

There are reasons one may discount this concern. As a practical matter, any firm with innovative technology faces competition in selling the government products containing innovative technology or the technology itself. Intellectual property rights protect such contractors' investments in research and development. Beyond that, there is no reason an SBIR grantee should necessarily be protected from competition if more than one company, large or small, can produce a product without violating intellectual property rights. The SBIR program is designed to create an environment where fledgling innovations can be developed into useful technology; it is not designed to create monopolies for grantees and venture capital firms. In fact, relevant case law puts SBIR grantees on notice that, in an extreme case, the failure to mark a prototype item developed under a Phase II grant with an intellectual property legend can be justification for an agency to disclose technology to other potential offerors and effectively convert what would likely be a sole-source SBIR Phase III award into a competitive procurement.¹⁴ Similarly, small businesses seeking to grow their business by expanding the amount of work they perform for the government face the natural dilemma that continued growth and success will eventually lead to a loss of the small status that may have fostered the growth in the first place. In short, one might justifiably ask, "Where's the problem?" This is a strong theoretical retort to the theoretical concern that affiliation for procurement purposes will inhibit the venture capital investment in current or prospective SBIR grantees.

The parties best positioned to shed light on whether these concerns are real or theoretical are SBIR grant recipients and applicants and their prospective venture capital backers. The public comment period for the Proposed Rule closed July 16, 2012, and most of the more than 250 comments received appear to involve criticism that the Proposed Rule may allow foreign ownership of SBIR grant recipients. It is not clear whether the concern regarding the potential "loss" of small business status SBIR grantees may undergo when transitioning from research and development to performance of follow-on competitive procurement contracts has registered in the venture capital and small business communities. Even if those constituencies become vocal, it is not clear whether the SBA could or would create an exception to affiliation principles governing size for general procurement purposes for venture capital-backed SBIR grantees. Regardless, current or prospective SBIR grantees excited by the prospect of venture capital backing should be wary of the possibility that involvement with venture capital firms may undermine their size status for procurement purposes. **TFL**

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Endnotes

¹77 FR 28520-30 (May 15, 2012). The Proposed Rule would also apply to the Small Business Technology Transfer (STTR) program. The STTR and SBIR programs are both designed to increase the participation of small businesses in, and increase private sector commercialization of technology development through, federal research and development. The main difference between the two programs is that the STTR program requires the small business concern applicant organization to formally collaborate with a research institution in initial phases, whereas the SBIR program does not require that sort of collaboration.

²See 13 C.F.R. § 121.201.

³See 13 C.F.R. § 121.103.

⁴U.S. Small Business Administration, *Small Business Innovation Research Program (SBIR)*, at www.sba.gov/content/small-business-innovation-research-program-sbir-0 (last visited May 17, 2012).

⁵*Id.*

⁶13 C.F.R. § 121.702(a).

⁷*Emerald Biostructures Inc.*, SBA No. SIZ-5221 (Mar. 29, 2011) ("[I]t appears that SBA actually intended to limit corporate ownership of SBIR concerns to the specific circumstances described in [the] regulation.").

⁸Jessica Tillipman & Damien Specht, *Venture Capital Investment & Small Business Affiliation Rules: Why a Limited Exception is Crucial to Economic Recovery Efforts*, 21 THE CLAUSE 1:36 (Dec. 2010).

⁹National Defense Authorization Act for Fiscal Year 2012, Pub. L. No. 112-81, 125 Stat. 1298 §§ 5107(a), 5108.

¹⁰77 FR 28528 (May 15, 2012).

¹¹*Id.* at 28529 ("affiliation may be found for other reasons").

¹²13 C.F.R. § 121.103. Under procurement size standards, it is possible for business entities to own stock in a small business without affiliation arising, but only if another shareholder has a sufficiently large share that she can exercise control over the company. *Id.* § 121.103(c). If the voting authority of a business entity shareholder is sufficient to exercise control effectively over the company (*i.e.*, its stake in the company is the same size or larger as compared to other shareholders' stakes, regardless of whether it is a majority owner), then affiliation will arise. *Id.* Otherwise, SBA's size regulations for procurement contain a few exceptions related to ownership by certain qualified investment companies, pension plans and the like, but those exceptions are substantially less broad than the Proposed Rule's venture capital exception to affiliation. The Proposed Rule would amend section 121.103 to provide that the exceptions to affiliation listed there apply to the SBIR and STTR programs, *but not* that the exceptions to affiliation listed in the Proposed Rule would extend to the general affiliation rules for procurement purposes.

¹³See 48 C.F.R. §§ 1.102(b)(1)(iii), 19.201(a).

¹⁴*Night Vision Corp. v. United States*, 68 Fed. Cl. 368, 379-81 (2005).