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ALERT

Venture Capital-Owned Small Businesses Now Eligible to Receive Certain SBIR Awards

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On December 27, 2012, the U.S. Small Business Administration (SBA) issued a final rule amending its regulations governing size and eligibility for the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs. The rule implements provisions of the National Defense Authorization Act for Fiscal Year 2012 (FY12 NDAA). The rule addresses ownership, control and affiliation for participants in the SBIR and STTR programs, including participants that are majority-owned by multiple venture capital operating companies (VCOCs), private equity firms or hedge funds.

The most significant aspect of the rule for many in industry is that agencies are no longer restricted to making SBIR awards to small business concerns that are at least 51% owned and controlled by (1) individuals who are U.S. citizens or permanent resident aliens, or (2) another business concern that is itself at least 51% owned and controlled by individuals who are U.S. citizens or permanent resident aliens. This requirement has increasingly prevented firms receiving venture capital investment from participating in the SBIR program, as they generally are not owned by "individuals" or another business concern that is itself owned by individuals. Many small businesses have criticized this requirement as out-of-date and inconsistent with the corporate structures of today's small businesses, particularly those that must rely on venture capital funding in industries requiring significant up-front expenditures.

Under the FY12 NDAA and SBA's final rule, agencies are now permitted to make SBIR awards to small business concerns that are more than 50% owned by multiple VCOCs, hedge funds, private equity firms, or any combination of these. Ownership must be by multiple venture capital firms, however—no single VCOC, private

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Small Business Programs and Nontraditional Defense Contractors equity firm or hedge fund may own more than 50% of the concern. In addition, to ensure that SBIR dollars are being spent on domestic firms, the VCOC, private equity firm or hedge fund must have a place of business located in the United States and be created or organized in the United States, or under the laws of the United States or any state. Although SBA originally proposed to allow venture capital-backed firms to participate in the STTR program as well, upon review SBA decided that such businesses should not be eligible for STTR awards. The rule thus sets forth separate eligibility criteria for the SBIR and STTR programs. An SBIR or STTR awardee, together with its affiliates, still must have 500 or fewer employees.

The SBA's rules concerning "affiliation" will continue to apply to SBIR awardees, including those owned by venture capital firms, with some minor changes. For determining affiliation based on equity ownership of an SBIR or STTR awardee, a concern will be considered affiliated with an individual or entity that owns or has the power to control more than 50% of the concern's voting equity. The SBA may also find affiliation if an individual or entity owns or has the power to control 40% or more of the voting equity of a concern based upon the totality of circumstances. If no individual or entity is found to control, SBA will deem the Board of Directors to be in control of the concern. SBA will review the small business' equity ownership on a fully diluted basis. As with the SBA's "normal" affiliation rules, SBIR and STTR awardees can also be found affiliated with individuals and entities based on stock options and convertible securities, agreements to merge, common management, identity of interest, the newly organized concern rule, joint ventures, the ostensible subcontractor rule, license agreements and the totality of the circumstances.

Significantly for "traditional" small businesses that have not received venture capital funding, venture capital-controlled firms will not be eligible for all SBIR awards. The FY12 NDAA authorizes the National Institutes of Health, the Department of Energy and the National Science Foundation to award up to 25% of their SBIR funds to such businesses. All other agencies may award up to 15% of their SBIR funds to venture capital-backed companies. In order to make an SBIR award to these firms, the agency must first provide a written determination to the SBA Administrator and Congress that the award is justified in that particular case.

Small business concerns that are majority-owned by multiple VCOCs, hedge funds, or private equity firms and qualified for participation must register with the SBA, in the Company Registry Database at *www.SBIR.gov,* as of the date they submit an application in response to an SBIR solicitation or announcement. These firms must also indicate in any SBIR proposal that they have completed this registration. SBA previously provided more detailed guidance about the registration requirements in two August 6, 2012 Program Policy Directives, available here and here. Firms will be required to provide basic identifying information about the concern, the number of employees, the percentage ownership of the concern held by VOCO, hedge fund or private equity, and similar information about the concern's affiliates. The data collected in the Company Registry Database will not be shared publicly. According to the final rule, the SBA is still working on creating a database, which would be part of the SBIR/STTR system known as Tech-Net.