

Corporate & Securities Advisory

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Proposed SBIR Rules Published – Planning for Changes to SBIR-Funded Company Investments

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On May 15, 2012, the U.S. Small Business Administration (SBA) published a [proposed rule](#) to amend regulations governing eligibility for the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) Programs to implement provisions of the SBIR/STTR Reauthorization Act of 2011, which was included as part of the FY12 National Defense Authorization Act (NDAA). The NDAA reauthorized the SBIR Program for six years and now allows small firms that are majority-owned by venture capital operating companies (VCOCs), hedge funds, or private equity firms to receive SBIR grants. The conditions imposed upon such investors will affect the structure of investments in SBIR-funded companies. This advisory briefly summarizes the most important changes to the SBIR eligibility rules being considered* and briefly discusses how investments in or acquisitions of SBIR-funded companies may be affected.

*The recent publication is a proposed rule and subject to change, but the most material changes are required by the NDAA, and thus are likely to survive in the final rule to be published later this year.

Summary of Proposed Changes to SBIR Eligibility

Currently, an entity is eligible to receive an SBIR grant if it is operated for profit, has a place of business in the US, and is at least 51% owned and controlled by US citizens or permanent resident aliens, or at least 51% owned and controlled by another business that is at least 51% owned and controlled by US citizens or permanent resident aliens. The SBIR applicant, together with its affiliated entities, must have fewer than 500 employees. Eligibility is determined as of the date the SBIR funds are awarded.

The NDAA and its implementing rules will make significant changes to these eligibility criteria.

- The proposed rule newly defines a “domestic business concern” as a for profit business, which is organized under the laws of any US state, that maintains a place of business in the US and that operates primarily in the US or makes a significant contribution to the US economy. Importantly, a domestic business concern need not be owned by US citizens or resident aliens, or by another US business.
- The proposed rule changes the ownership and control requirements for SBIR eligibility. A SBIR applicant must be either (i) more than 50% owned and controlled by US citizens, permanent resident aliens, or domestic business concerns, or (ii) must be majority-owned by multiple domestic VCOCs, hedge funds or private equity funds. No single VCOC, hedge fund, or private equity fund may own more than 50% of the SBIR applicant.
- For purposes of determining the number of employees of the SBIR applicant and its affiliates, the proposed rule modifies some of the current affiliation rules solely for purposes of SBIR eligibility (the affiliation rules for other small business programs are not affected). The minority stock ownership rule is modified to provide that if two or more persons (including entities) each own or

control less than 50% of the voting stock, then the board of directors (not the large minority shareholders) is deemed to control the SBIR applicant. The affiliation rule is also modified to provide that an SBIR applicant is not deemed to be an affiliate of another portfolio operating company of a VCOC, hedge fund, or private equity fund solely on the basis of one or more shared investors (although affiliation may be found for other reasons, such as common management). There is also a new exception to affiliation for SBIR applicants that are portfolio companies of a VCOC, hedge fund, or private equity fund. The investor VCOC, hedge fund, or private equity fund is not an affiliate of the SBIR applicant unless the investor either (i) owns a majority of the portfolio SBIR company or (ii) holds a majority of seats on the board of the portfolio SBIR company.

- Under the current rule, eligibility for Phase I and Phase II SBIR grants is determined on the date of award of the funding. Under the proposed rule, eligibility will be determined *both* on the date the SBIR solicitation is announced *and* on the date of award, and an SBIR applicant that is majority-owned by two or more VCOCs, hedge funds, or private equity funds must register with the SBA before applying for SBIR funding.

New Rules – New Ownership Structures

Under the proposed rules, domestic venture firms and other private equity investors will be able to take majority positions in SBIR applicants, provided that no single firm owns a majority interest in the SBIR company. The investor need not be majority-owned by US citizens. Provided that each private equity investor owns and controls only a minority share of voting stock and board seats, it will be able to include the SBIR company in its portfolio without aggregating the employees of its other portfolio companies with the SBIR company's employees for purposes of the SBIR size determination. Unlike current law, however, a single venture fund, hedge fund, or other private equity fund will not be able to own more than 50% of the voting shares in an SBIR company, even if the investor fund is owned entirely by US citizens.

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