

## **SBIR Improvements -- Allowing Majority Investor Participation and More**

On December 31, 2011, President Obama signed the National Defense Authorization Act for 2012, which included the SBIR/STTR Reauthorization Act of 2011 (the "Act"). H.R. 1540-526, Division E. Many changes, large and small, were made to the Small Business Innovation Research Program ("SBIR") and the Small Business Technology Transfer Program ("STTR"). The Small Business Administration ("SBA") is required to issue proposed regulations implementing the Act generally by April 30, 2012, and regarding fraud, waste, and abuse prevention by March 30, 2012.

For basic information about the SBIR/STTR programs, see the [SBA's website](#). Generally:

SBIR targets the entrepreneurial sector because that is where most innovation and innovators thrive. However, the risk and expense of conducting serious R&D efforts are often beyond the means of many small businesses. By reserving a specific percentage of federal R&D funds for small business, SBIR protects the small business and enables it to compete on the same level as larger businesses. SBIR funds the critical startup and development stages and it encourages the commercialization of the technology, product, or service, which, in turn, stimulates the U.S. economy.

STTR is a highly competitive program that reserves a specific percentage of federal R&D funding for award to small business and nonprofit research institution partners. Small business has long been where innovation and innovators thrive. But the risk and expense of conducting serious R&D efforts can be beyond the means of many small businesses.

*Id.*

The most interesting and complex change is to permit small business concerns that have majority investments by venture capital, hedge fund, or private equity firms, even if the investment firms are large businesses, to receive a portion of SBIR awards. That topic is discussed in detail later in this article.

### **General Changes**

A top level list of changes that are also significant, but are relatively simple, include:

- Increase in the percentage of the agency's extramural research and development budget to be allocated to SBIR (2.6% in 2012 through 3.2% in 2017) and STTR (.35% in 2012 through .45% in 2016)
- Increase in the value of the awards to \$150,000 in Phase I and \$1M in Phase II for both SBIR and STTR
- Phase II awards may be from a different agency than the Phase I award where both agencies make written determinations that the topics are the same

- Phase II awards should be made following completion of a Phase I agreement without any invitation, pre-screening, or pre-selection process for eligibility for Phase II
- Phase II awards may be made to applicants that have not performed a Phase I agreement
- Not only must the applicant assert that each application is not duplicative of another application, the federal agencies must also verify there is no duplication of funding
- Federal agencies may not make collaboration with a federal laboratory a condition to award of an SBIR or STTR agreement
- Federal agencies may not approve any agreement (the Act focuses on Cooperative Research and Development Agreements) that takes more rights in data from the small business concern than the defined SBIR rights
- A federal laboratory may not require advance payment from a small business concern any greater than the amount necessary to pay for 30 days of activities
- For Department of Defense ("DoD") contracts of \$100M or more, goals for transition of Phase III technologies must be required in subcontracting plans
- Allows agencies to use 3% of SBIR funding for and requires agencies to provide technical assistance, outreach, oversight, implementation of commercialization, and related activities
- Requires agencies to make a final decision whether to make awards within 90 days after the solicitation closes, except the NIH and NSF are permitted one year
- NIH authorized \$5M for special "Phase 0" Proof of Concept Partnership Pilot Program to accelerate the creation of small businesses and the commercialization of research innovations from qualifying institutions
- Requires the Comptroller General to conduct a fiscal and management audit to determine, among other things, whether the agencies comply with the expenditure amount requirements
- Requires the Comptroller General to conduct a study of the SBIR program to assess whether federal agencies comply with the data rights protections for SBIR awardees and their technologies, whether the data rights protection laws and policies are sufficient to protect SBIR awardees, and if there are effective grievance tracking and resolution processes regarding data rights

### **Fraud, Waste and Abuse Prevention Changes**

- Requires SBIR and STTR applicants to make fraud, waste, and abuse compliance certifications at various stages in the award, performance and close-out of the agreements, which *may* require:
  - Certification of compliance with the "principal investigator primary employment" requirement, the "small business concern" definition requirement, and the "performance

of work" (in STTRs 40% of the work by the small business and 30% by the research institution) requirement

- Certification that it is not applying for funding for identical or essentially equivalent work to that already performed, or will perform, in connection with any other SBIR or STTR award from any other agency
- Certification that it will perform the work at its facilities with its employees unless otherwise indicated

### **Changes Permitting Venture Capital, Hedge Fund, and Private Equity Investment in SBIR**

Requirements to be eligible to receive an SBIR award include:

- U.S.-owned and under independent control
- For-profit
- The principal researcher must be employed by the business
- Company size limited to 500 employees

In 2006, venture capital, hedge fund, and private equity firms (hereinafter referred to collectively as "Investment Companies") were shocked to learn that the SBA may consider the Investment Company and all of its portfolio companies affiliated for purposes of determining company size under the SBA's affiliation rule. 13 CFR § 121.103(a). For purposes of SBIR program eligibility, if the aggregate of the number of employees of all of the portfolio companies and the Investment Company together exceeded 500, none of the portfolio companies would be eligible for the SBIR program. No specific regulation describing this situation was ever issued, but the SBA's decision in the size protest of *Apptis, Inc.*, SIZ-2006-10-06-56 interpreted the SBA's affiliation rule in a manner that treated the Investment Companies more like traditional corporate parents than banks. The *Apptis* case recognized some exceptions and in subsequent size protests, the SBA recognized additional exceptions, but Investment Companies have lacked certainty. It has become difficult to predict whether a small business would be able to retain the contracts it was performing after a transaction with an Investment Company. This has had a chilling effect on Investment Company activity in the federal government contractor small business space.

For well over a decade, the SBA and its stakeholders have been wrestling with a means to permit private investment, as it typically occurs in the marketplace, while still preserving the SBIR program for independent, small businesses. If an agency determines it is in its best interest, the Act now authorizes a federal agency to use a portion of its SBIR funds to award SBIR contracts to small business concerns with majority investments by Investment Companies:

- The National Institutes of Health ("NIH"), the Department of Energy ("DOE"), and the National Science Foundation ("NSF") may award up to 25% of its SBIR funds and all other federal agencies may award up to 15% of their SBIR funds to small business concerns that are owned in majority part by multiple Investment Companies

The Act has created an express exception to the affiliation rule (hereinafter referred to as the "15/25% Rule"). The exception applies to small business concerns where the majority interest is owned by *multiple* Investment Companies, not one Investment Company. Anyone experienced in the SBA affiliation rules knows that there is often a great deal of uncertainty in determining whether a relationship

has been established in a manner that will not create unwanted affiliation. Congress has attempted to gain some certainty for the investment community in the Act:

- The SBA must submit a report to Congress analyzing what restrictions, conditions, or covenants contained in a note, bond, debenture, or other evidence of indebtedness, or preferred stock should constitute affiliation under the SBA rules.

In general, the Act's guidance to determine if an Investment Company or any other business that the Investment Company has financed creates an affiliation with the applicant that makes it ineligible for SBIR is:

- If the Investment Company that is determined to be affiliated with an applicant is a minority investor in the applicant, the portfolio companies of the Investment Companies shall not be determined to be affiliated with the applicant unless
  - The Investment Company owns a majority of the portfolio company *or*
  - The Investment Company holds a majority of the seats on the board of directors of the portfolio company
- The SBA may not determine that a portfolio company of an Investment Company is affiliated with an applicant based solely on 1 or more shared investors
- The SBA retains discretion to consider other factors in affiliation

By January 30, 2012, the SBA is required to:

- Post on the SBA website a clear explanation of the *current* SBIR and STTR affiliation rules *and*
- Post on the SBA website contact information for SBA officers or employees who:
  - Upon request, shall review an issue relating to the affiliation rules *and*
  - Respond to a request not later than 20 business days after the date on which the request is received
- On and after the date when the new rules are made final, similarly post a clear explanation

Implementation of the 15/25% Rule will be a major challenge for agencies since the awards to SBIR companies with majority ownership by investment firms must be made through competitive, merit-based procedures that are open to all eligible small business concerns and may *not* use investment by an Investment Company as an evaluation criterion. This requirement will make it difficult to spread the awards across topics or organizational subunits of the agency, if that would be the agency's preference. There are several accounting and reporting requirements to implement the new authority:

- An SBIR/STTR awardee must:
  - Register with the SBA if it is majority-owned by multiple Investment Companies on the date that it submits an application for an SBIR award

- Report on any SBIR proposal that it is registered as majority-owned by multiple Investment Companies
- An SBIR/STTR awardee must also report significant information, most is which is made available publicly:
  - The amount of Investment Company investment that the awardee has received as of the date of the award
  - The amount of additional capital that the awardee has invested in the STTR technology
  - Whether an awardee has an investor that
    - Is an individual who is not a citizen of the United States of a lawful permanent resident of the United States, and, if so, the name of any such individual
    - Is a person that is not an individual and is not organized under the laws of a State or the United States, and if so, the name of any such person
  - Whether an awardee is owned by a woman or has a woman as a principal investigator
  - Whether an awardee is owned by a socially or economically disadvantaged individual or has a socially or economically disadvantaged individual as a principal investigator
  - Whether an awardee is a faculty member or a student of an institution of higher education
  - Whether an awardee is located in certain States that have been identified as receiving a disproportionately low share of SBIR/STTR awards

The Act even addresses an anticipated issue -- if a small business concern has a majority of its interests purchased after submission of an SBIR application, but before award:

- If the award is made more than nine (9) months after the application is submitted, an award to the applicant can be made as though the Investment Company ownership does not exist, *but*
- The agency must transfer the amount of the award from its non-SBIR fund account to the SBIR fund account.

The Act requires regulations to establish the criteria for meeting the U.S. owned and operated requirement, including:

- Whether the applicant is at least 51 percent owned or controlled by citizens of the United states or domestic Investment Companies
- Whether the applicant is domiciled in the United States
- Whether the applicant is a direct or indirect subsidiary of a foreign-owned firm

- Any Investment Company that owns more than 20 percent of the applicant is a direct or indirect subsidiary of a foreign-owned entity
- In the aggregate, entities that are direct or indirect subsidiaries of foreign-owned entities own more than 49 percent of applicant

Finally, Congress requires the Comptroller General to produce a report every three (3) years to describe the impact of the Investment Company requirements and involvement on the SBIR and STTR programs.

The Act was drafted with great specificity, which should leave the SBA with little discretion in drafting implementing regulations, and perhaps making the drafter's job easier. The rules are fairly complex, but companies and investors can manage their relationships to take advantage of the new SBIR/STTR rules, once implemented.

Should you have any questions about the contents of this alert, please feel free to contact [Holly Emrick Svetz](#); 703-394-2261 or any member of our [Government Contracts Team](#).

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