Government Contracts SBIR Series

How Acquisitions and Venture Capital Funding Impact Eligibility for SBIR Awards

Success for companies participating in the Small Business Innovation Research (SBIR) program takes many forms, including increased sales, licensing deals, and the reputational boost that comes with being an SBIR awardee. For many SBIR firms, success is being acquired by a larger company or raising funds to further grown their business. Before an acquisition or accepting funding from a venture capital or private equity firm, however, SBIR firms should understand the impact these transactions can have on their eligibility for SBIR awards.

SBIR Eligibility Basics

To be eligible for an SBIR award, a company must:

(i) Be a concern which is more than 50% directly owned and controlled by one or more individuals (who are citizens or permanent resident aliens of the United States), other small business concerns (each of which is more than 50% directly owned and controlled by individuals who are citizens or permanent resident aliens of the United States), an Indian tribe, ANC or NHO (or a wholly owned business entity of such tribe, ANC or NHO), or any combination of these;

(ii) Be a concern which is more than 50% owned by multiple venture capital operating companies, hedge funds, private equity firms, or any combination of these; or

(iii) Be a joint venture in which each entity to the joint venture must meet the requirements set forth in paragraphs above.

Most SBIR firms qualify under the first eligibility prong above. Under the first prong, the key requirement is that the firm must be at least 50% owned directly or indirectly—through no more than one corporate layer—by actual people. Ownership through multiple corporate entities or holding companies does not meet this test.

In addition to the 50% ownership requirement, a SBIR awardee, together with its affiliates, must not have more than 500 employees. Affiliation can exist for many reasons, but the basic rule is that firms are affiliated when one controls or has the power to control the other or a third party has the power to control both.

Acquisitions Involving SBIR Awards

The size and eligibility status of a SBIR awardee is determined at the time of award. Generally, if a firm is determined to be SBIR-eligible at the time of award, it is considered eligible throughout the life of the SBIR award. If a SBIR awardee is acquired, however, the awardee must recertify its size status within 30 days of the transaction becoming final. If the awardee is no longer small, the agency can no longer fund the options or issue a continuation of the SBIR award, from that point forward, using SBIR funds.

After an SBIR awardee is acquired, it will generally be deemed affiliated with the acquiring entity. The SBIR's size status is then determined by adding its employees to the acquiring entity's employees, plus the employees of any other companies controlled by the acquiring entity.

Venture Capital Funding for SBIR Awardees

The recertification requirement is not triggered when a SBIR awardee receives a minority investment from a venture capital or private equity firm. Accepting funding could impact a firm's eligibility for future SBIR awards, though.

As noted above, to be eligible for an SBIR award, the firm must be at least 50% owned directly or indirectly (through no more than one corporate layer) by actual people. If the venture capital funding is provided through an investment vehicle that involves multiple corporate entities, the funding may cause the SBIR firm to fall below the 50% threshold.

Venture capital funding can also give rise to affiliation. If the minority investment comes with a board seat or gives the venture capital firm the ability to exercise negative control over the company—by, for example, the right to veto certain major business decisions—the venture capital company may be deemed affiliated with the SBIR firm. In that case, the size status of the SBIR firm would be determined by adding its employees to the employees of the venture capital firm, plus any other companies that the venture capital firm controls.

The Venture Capital Exception

In 2013, the SBIR rules were changed to allow companies that are majority-owned by venture capital or private equity firms to be eligible for SBIR awards. The change was made in response to criticism that many small businesses rely on venture capital funding to compete in today's economy, especially in industries requiring significant up-front expenditures.

Under the venture capital exception, a company is eligible for SBIR awards if it is more than 50% owned by multiple venture capital or private equity firms, provided:

(i) No single venture capital operating company, hedge fund, or private equity firm may own more than 50% of the concern (unless that single venture capital operating company, hedge fund, or private equity firm qualifies as a small business concern that is more than 50% directly owned and controlled by individuals who are citizens or permanent resident aliens of the United States);

(ii) The company is registered with the Small Business Administration in the Company Registry Database; and

(iii) The agency elects to use its authority to award SBIR funds to companies majority-owned by multiple venture capital operating companies, hedge funds, or private equity firms (agencies can only spend a certain percentage of their SBIR funding to such companies), and makes a determination that such an award is justified in each case.

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Being acquired or receiving an infusion of capital is a significant achievement for any participant in the SBIR program. Firms would be well advised to understand the impact of such transactions on their current and future SBIR awards.

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