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

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Last month, the U.S. Small Business Administration (SBA) finalized highly-anticipated changes to its regulations governing eligibility for the Small Business Innovation Research (SBIR) program. The new rules, issued on December 27, 2012, implement provisions of the National Defense Authorization Act for Fiscal Year 2012 (FY12 NDAA) requiring the SBA to revise its regulations for the SBIR program to allow for participation by small businesses that are majority-owned by multiple venture capital operating companies (VCOCs), private equity firms or hedge funds. Although venture capital-owned small businesses will not be eligible for all SBIR awards going forward, this is nonetheless a significant change that will likely open up more SBIR opportunities for these firms.

By way of background, the SBIR program is an SBA-coordinated program in which Federal agencies with extramural research and development (R&D) budgets exceeding $100 million are required to allocate 2.5% of those budgets for contracts or grants to small businesses. Through a competitive awards-based program, SBIR encourages domestic small businesses to engage in R&D projects and explore their technological potential by providing incentives for the small businesses to profit from its commercialization. Nearly a dozen Federal agencies currently participate in the SBIR program, including the Department of Defense, Department of Energy, Department of Health and Human Services, Department of Homeland Security and the National Aeronautics and Space Administration. The Small Business Technology Transfer (STTR) program is a companion program to SBIR that funds cooperative research and development projects with small businesses in partnership with not-for-profit research institutions (such as universities) to move research to the marketplace.

Historically, participation in the SBIR and STTR programs has been limited 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 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. SBIR and STTR awardees can also be found affiliated with individuals and entities deemed to control the SBIR/STTR awardee for other reasons, such as Board participation, common management, or the ability to exert “negative control” through a loan agreement.

Significantly, 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. 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.

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