New SBIR Legislation May Increase Venture Capital Investment

by Leslie H. Lepow and Damien Specht

Lost in the controversy over the so-called “indefinite detention” provisions in the Fiscal Year 2012 National Defense Authorization Act is a piece of good news for cutting edge small business government contractors and firms looking to invest in them. Specifically, after years of delays and half-measures, Congress has finally taken action to extend the Small Business Innovation and Research (“SBIR”) program for a period of longer than a single year. This extension comes with a series of reforms of importance to small businesses and venture capital investors, as the new legislation expands the size of SBIR awards and expands access to the program for venture capital-backed firms. Although this expansion comes with some risks, these changes should create new investment opportunities for a variety of firms.

Since 1982, the SBIR program has provided small businesses in the early stages of research and development with government funding and support. The program offers a series of benefits including federal funding, technical assistance and follow-on production contracts while allowing small businesses to retain all-important intellectual property rights. The SBIR program gives small businesses—and now their venture capital backers—access to a large pool of grant funds. The Government Accountability Office reported in 2009 that “[f]rom its inception . . . through fiscal year 2004, federal agencies had awarded over $17 billion for more than 82,000 projects.”[1] The program has proven to be successful, spurring significant technological innovations at a higher rate than traditional federal research[2] and delivering approximately 30 times the Government’s initial investment.[3] The program currently accounts for more than 50,000 patents, averaging more than seven patents per day and outstripping all U.S. universities combined.[4] SBIR participants have the potential for extensive federal and non-federal sales. For example, the Department of Defense reported in 2010 that its current and former SBIR recipients had generated $22 billion in sales.[5]

However, there has always been tension between SBIR participation and venture capital investment. Until recently, to participate in the SBIR program a business had to meet two iron-clad requirements: (1) majority ownership and control by individuals[6] who are U.S. citizens or permanent resident aliens (or by another business that is itself majority-owned and controlled by individuals who are U.S. citizens or permanent resident aliens) and (2) have 500 or fewer employees (including the employees of its affiliates).[7] Each of these points posed challenges for venture capital investment as they were not “individuals” and, even if they could clear this hurdle, these firms generally have many more than 500 affiliated employees among their investments. Venture capital firms and some small businesses raised concerns that this situation...
stifled investment, particularly in the areas of biotechnology and the life sciences, where up-front expenditures can overwhelm small concerns with limited capital. On the other hand, some small businesses argued that allowing firms that already had majority venture capital funding into the program undercut the entire purpose of the SBIR program.

While taking into account the purposes of the SBIR program to provide capital to firms that do not have easy access to funding, Congress responded to venture capital firms’ concerns in the National Defense Authorization Act for Fiscal Year 2012, which President Obama signed into law on December 31, 2011. The Act significantly increases the amount of federal money dedicated to the SBIR program as well as expanding the maximum size of each individual SBIR award. The Act also creates a pilot program whereby the National Institutes of Health, the Department of Defense, and the Department of Education can make Phase II SBIR awards to companies for projects that were not previously the subjects of a Phase I award—something not permitted before.

However, perhaps the most striking change in the Act and the area of most interest to venture capital investors is permission for agencies, notwithstanding the general prohibition of control or ownership by non-individuals, to award SBIR funds on a competitive basis to small business concerns “that are owned in majority part by multiple venture capital operating companies, hedge funds, or private equity firms.” There are a few key points to consider when evaluating this new opportunity:

1. Ownership must be by multiple venture capital firms. By implication, majority ownership or control by a single venture capital firm will not qualify an SBIR firm for access to the program. Forthcoming regulatory guidance will presumably clarify the precise contours of this requirement.

2. In deference to traditional small businesses in search of early stage funding, not all SBIR funds are available to venture capital-controlled firms. The new legislation 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. The other participating agencies may award up to 15% of their SBIR funds under this relaxed standard. The majority of awards will still be reserved for businesses that meet the traditional SBIR ownership requirements.

3. A specific agency determination is required. Before making an award under the new rule, the relevant agency head must make a written determination that the relaxed standard is justified for a specific award.

4. SBIR funds continue to be unavailable to companies majority-owned or controlled by a large business or foreign entity. The new law does not address the situation of an SBIR firm majority-owned or controlled by multiple venture capital companies, none of which independently has majority ownership or control over the firm. Nor is it clear how the venture capital companies’ size and nationality will be determined, or how that will affect the size and nationality of the SBIR firm in question. Further guidance on these rules will likely be found in upcoming SBA regulations.

This new investment opportunity also comes with a new focus on transparency. In order for a venture capital-controlled firm to qualify for SBIR awards, it must register as majority-owned by multiple venture capital operating companies, hedge funds, or private equity firms. Moreover, every SBIR awardee must state whether it has received any venture capital, hedge fund, or private equity firm investment or is majority-owned by such entities. If so, it must disclose the amount of such investment received since award date and the amount of additional capital the small concern has invested.
in the SBIR technology. This information will be publicly disclosed through the already-existing SBIR database. In addition, each awardee must disclose “the percentage of ownership of the awardee held by a venture capital operating company, hedge fund, or private equity firm.” For now, this information will appear only in the already-existing, non-public Government database of SBIR fund recipients. The law does not specify whether awardees must identify the specific venture capital companies that have invested or have ownership stakes in them or, if so, whether that information will appear in the public database. However, it seems likely that this data will be required in order to substantiate the ownership percentages claimed.

Of course, just because the new law allows for venture capital investment does not guarantee that every business that desires outside capital will get it. First, small businesses interested in attracting more investment must convince venture capital companies to invest in SBIR projects, which typically involve relatively risky, nascent technologies that are prone to failure. Second, venture capital companies must consider whether the return on an SBIR investment—including lucrative follow-on contracts—justifies the disclosure requirements that SBA will impose. Finally, as was the case before these amendments, small concerns and venture capital companies alike must pay close attention to affiliation and control issues so as not to run afoul of the SBIR’s restrictions on size and foreign ownership or control.

SBA’s forthcoming regulatory guidance will enable companies to make prudent choices with regard to their participation in the SBIR program. Congress has instructed the SBA to promulgate regulations to provide more complete guidance and to fill in the gaps left by Congress. Among other items, SBA must consider criteria for determining the effect of being a direct or indirect subsidiary of a foreign-owned entity, the aggregate effect of ownership by multiple indirect subsidiaries of foreign entities, and the impact of one particular venture capital company’s owning more than 20% of a business if the venture capital company is a direct or indirect subsidiary of a foreign entity. Of course, foreign control of or significant foreign interest in a venture capital company may also trigger other obligations, including Foreign Ownership, Control, or Influence (“FOCI”) disclosures. SBA must also develop similar criteria for determining the size of a venture capital-controlled SBIR firm, and Congress has instructed SBA to count a venture capital company’s portfolio companies as its affiliates whenever it has majority ownership or control over them. These regulations will be out soon, as the legislation requires a “clear explanation” of relevant affiliation rules on SBA’s website within 30 days of the Act’s enactment and issuance of an interim or final rule within one year. These regulations should help clarify the affiliation, size, and nationality questions raised by greater venture capital participation in the SBIR program.

In sum, this new law puts the SBIR program on solid ground for the next six years, rather than relying on year-to-year reauthorizations. This consistency will help agencies plan allocation of research dollars and will encourage greater participation in the program by small firms. In addition, a greater percentage of funds will flow to the program, larger awards can be made, and agencies can make awards to businesses that could not previously have participated in the program. This increases the number of small business concerns eligible for these grants and enables venture capital companies to invest in these companies from the beginning. However, venture capital firms and small businesses alike should pay special attention to SBA’s forthcoming regulations as the details of the program’s implementation will have a significant impact on whether this new opportunity is worth the cost of increased transparency and possible loss of size status due to affiliation.
ENDNOTES


[8] The Act also reauthorizes and makes changes to the Small Business Technology Transfer (“STTR”) program.

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