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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How SBIR/STTR Regulation Will Impact Investment Firms

Law360, New York (May 23, 2012, 1:18 PM ET) -- On May 15, 2012, the Small Business Administration issued a proposed rule amending the regulations that govern the Small Business Innovation Research ("SBIR") and Small Business Technology Transfer ("STTR") programs. The proposed rule highlights new risks and opportunities for investors in small business concerns that are established to capture SBIR/STTR funding. This article analyzes and comments on the proposed rule.

The proposed rule[1] implements the SBIR Re-Authorization Act, which Congress passed as part of the 2012 National Defense Authorization Act.[2] The proposed rule amends the size eligibility requirements for the SBIR and STTR programs by addressing ownership, control and affiliation issues raised by the act.

In accordance with the act, the proposed rule permits participation in the SBIR and STTR programs by small business concerns that are majority-owned by multiple venture capital operating companies ("VCOCs"), hedge funds ("HFs") or private equity groups ("PEGs") (collectively, "investment companies"). The proposed rule focuses on the most controversial aspects of the act, relating to the impact that investment company participation may have on the size and eligibility of SBIR/STTR applicants.

As discussed below, the proposed rule will impact investment companies' ability to participate in these two programs. In addition, more changes are likely, both because the proposed rule contemplates significant public outreach, and because the proposed rule does not address a number of the act's provisions.

Background

Congress established the SBIR program in the Small Business Innovation Development Act of 1982, and the Small Business Technology Transfer Act of 1992.[3] Congress reauthorized the SBIR/STTR programs in 2000, through 2008. Since 2008, the SBIR/STTR programs have been extended temporarily 14 times. As part of the 2012 NDAA, Congress put in place a long-term reauthorization, extending the programs through Sept.ember 30, 2017.

Prior to the act, the SBA's affiliation rule restricted firms majority-owned by investment companies from participating in the SBIR/STTR programs. The act significantly loosened this restriction, and required the SBA to issue implementing regulations relating to affiliation and ownership/control within 120 days.[4] The SBA timely issued the proposed rule substantially within the 120-day time frame, and stated that it intends to follow up with public outreach, including town hall meetings and webinars.

Proposed Amendments

Through the act, Congress amended the eligibility requirements for participation in the

SBIR/STTR programs. The SBA intends that the new regulations provide "a clear set of guidelines for small businesses to understand and a bright-line test by which small businesses can easily determine whether they meet the ownership, size, and affiliation requirements of the two programs."[5] The proposed rule requires that, to be eligible to participate in the programs, a small business concern must be:

- more than 50-percent owned by
  - U.S. citizens,
  - permanent resident aliens, or
  - domestic business concerns, or

- majority-owned by VCOCs, HFs or PEGs, none of which owns more than 49 percent of the concern.

Domestic Business Concerns

One new part of the revised eligibility test is the reference to "domestic business concerns." The act addressed foreign ownership of an SBIR/STTR applicant; as a consequence, the SBA revised the definition of "domestic business concerns." The SBA used its existing definition of "business concern" or "concern,"[6] and then added to that existing definition a new requirement that the entity "must be created or organized in the United States, or under the law of the United States or any State." This additional requirement will, for example, require small business concerns incorporated abroad to re-incorporate in the United States. This is largely a ministerial act and not particularly burdensome.

The New Role for Investment Companies

The great compromise on the part of Congress was the preferential treatment (encouragement) afforded to investment companies. Prior to the act, these entities faced a dilemma in investing in concerns participating in the SBIR/STTR programs (and, indeed, other small business programs). For many investment companies, the goal of investing in small business concerns is to take advantage of these companies' ability to win Phases I and II SBIR or STTR awards.

Yet, upon investment, the risk inevitably arose that the SBA would determine that the small business concern was affiliated with the investor and its entire portfolio; if all affiliated concerns exceeded the applicable size standard, the small business concern thus would be ineligible for continued Phase I or II funding. Frustration pervaded both the SBIR/STTR investor community and the small business community as well.

One of the main purposes of the act was to end this catch-22 for would-be SBIR/STTR investors. In accordance with the act, the proposed rule specifically allows firms that are majority-owned by multiple domestic investment companies to be eligible to participate in the SBIR/STTR program so long as no single investment company owns more than 50 percent of the small business concern.

Notably, the proposed rule does not appear to limit the degree of majority ownership. For instance, if a VCOC owns 49 percent, an HF owns 49 percent, and a PEG owns 2 percent, of a small business concern, there would be no issue with eligibility because none of the entities would own more than 50 percent of the small business concern. This major change, consistent with the act, ushers in a new era of investor ownership patterns for small business concerns that pursue SBIR/STTR funding.

As a result of this new preference and favorable treatment of investment companies, we

anticipate that large firms will make investments in SBIR/STTR-eligible concerns through such investment company entities. If the proposed rule becomes final with these provisions intact, one would expect large firms that are aggressive about investing in SBIR/STTR opportunities to create such entities.

However, since, as discussed below, the proposed rule excepts affiliation with portfolio companies held by investment companies, it remains to be seen whether the parent or other-affiliated companies of investment companies are also excluded from the affiliation rules, or if only completely independent investment companies can take advantage of these changes.

500-Employee Size Standard

While making a variety of other changes in SBIR/STTR eligibility, the SBA chose not to alter the 500-employee size standard for both programs. The rules also do not affect or alter technical data rights of SBIR/STTR firms.

Affiliation

Consistent with the act's prohibition against the SBA finding affiliation based solely on shared investors, the proposed rule implements a sea change in the application of the SBA's affiliation rules for the SBIR/STTR program.[7] The proposed rule creates new affiliation provisions in an SBIR/STTR-specific section of the regulations,[8] rather than addressing these issues in the existing affiliation rule,[9] thus making the affiliation changes only applicable to the SBIR/STTR programs. Consequently, SBA's affiliation rule remains intact for non-SBIR/STTR firms.

Generally, the proposed rule leaves intact the traditional tests for affiliation. For example, the SBA may presume affiliation:

- based on an identity of interest between family members with identical or substantially identical business or economic interests; or between concerns when one is contractually dependent on the other for 70 percent of its revenues, or dependent on loans supplied by the other, and the loans are made outside of arms-length transactions;

- when a person controls more than 50 percent of the voting stock of the concern, applying the "present effect" rule, by which stock options are given present effect; and the SBA will also give "present effect" to an agreement to merge (including an agreement in principle) or to sell stock;

- if one or more officers, managing members, general partners or the board of directors also controls the management of another concern;

- if the concern is "newly organized" by the principals of another concern in the same or related industry, and the original concern provides financial or technical assistance, whether for a fee or otherwise (this would include SBIR "spin-offs" or "spin outs");

- of joint venture partners;

- with "ostensible subcontractors;" and

- arising from license agreements, including common ownership or common management. However, a license agreement will not cause the licensor to be affiliated with the licensee if the licensee has the right to profit from its efforts and bears the risk of loss.

Under the proposed rule, the SBIR/STTR affiliation rules will deviate from the traditional affiliation rules in the following respects:

- where no one stockholder holds a majority interest in a concern, the proposed rule states that the board of directors controls the concern (i.e., the concern will not be deemed to be affiliated with its large stockholders). This rule stands in marked contrast with 13 C.F.R. § 121.103(c)(2) whereby, if two or more stockholders hold a minority interest in a concern, but that interest is equal or approximately equal in size and the aggregate of these minority holdings is large as compared with any other stock holding, then the SBA will presume that each such entity is affiliated with the concern;

- an SBIR/STTR applicant will not be deemed to be affiliated with a portfolio company of an investment company solely on the basis of one or more shared investors; and

- when any investment companies that are determined to be affiliated with the small business concern are minority investors in that concern, then the other portfolio companies (but no mention of other affiliates) of those investment companies are not affiliated with the small business concern, unless (1) the investment company owns a majority of any other portfolio company; or (2) the investment company holds a majority of the seats of the board of directors of any other portfolio company.

An issue which remains unclear is how the SBA's Office of Hearings and Appeals ("OHA") will address investors' use of so-called "negative covenants" in the provision of funding to small business concerns. Negative covenants are provisions in which consent of the investor is required for the SBIR/STTR-eligible concern to take a certain action. Negative covenants can arise from the need for investor-consent for distributing stock dividends, fund withdrawals, asset sales, loans in excess of an established amount, and so forth.

Although negative covenants are customary in industry agreements, the OHA has held on numerous occasions that negative covenants give rise to affiliation. Despite its substantial changes to the SBIR/STTR affiliation rules — allowing for small business ownership by investment companies — the proposed rule fails to address investors' use of negative covenants. The act and proposed rule may serve as a hollow victory for investment companies if the negative control issue continues to be applied in size protest cases by the OHA. It remains to be seen whether the OHA will apply the same affiliation standards and precedent to SBIR/STTR cases as it does to other small business cases. The proposed rule does not address this aspect of negative control.

Change in the Time at Which Size is Determined for SBIR/STTR Concerns

Without explanation, and absent any legislative mandate, the SBA altered the time at which

size is determined for SBIR/STTR applicants. Current regulations set the time of award as the time at which size is determined for SBIR/STTR applicants. The SBA now proposes to impose an additional requirement that the SBIR/STTR applicant in Phases I and II certify to its size status at the time of submission of its initial proposal, as well as at time of award.

The "time of award" rule allowed individuals to submit an SBIR/STTR proposal while still employed by another entity, to decide not to leave secure employment for the new firm until they know it had a contract. This was seen as promoting innovation and encouraging the formation of SBIR/STTR firms by allowing employees of large firms, nonprofits, laboratories, universities and so forth, to refrain from leaving their jobs in hopes of a Phase I or II award. These entrepreneurs could then make the move to their new small business venture upon award selection, but prior to award.

The SBA's new "time of proposal" aspect of the proposed rule means that many of these individuals — those whose current employers would not be eligible under the SBIR/STTR eligibility rules — will not be able to apply for an SBIR/STTR Phase I or II award while they remain employed. This forces individuals to make the decision to abandon safe employment for the new concern much earlier. As a result, fewer SBIR firms may be formed, and innovation may be chilled.

Change in Who May File a Size Protest

Under current rules, a size protest or request for formal size determination may be filed by a prospective offeror, the funding agreement officer, the responsible SBA government contracting area director or the division chief, Office of Innovation, or other "interested parties." The proposed rule would modify this list to include current offerors.[10]

Comments

Comments on the proposed rule are due to the SBA by July 16, 2012. Parties interested in submitting comments should be familiar with the provisions of the act, since any alternative approaches to, or disagreements with, the proposed rule will be rejected if they are not consistent with the act.

Firms and individuals who desire to submit comments on the proposed rule should be aware that the SBA intends to publicize all comments it receives at www.regulations.gov. If the comments contain proprietary or confidential business information, the submitter may request that its comments be withheld, but the SBA may determine to publish the comments nonetheless. Thus, we strongly advise commentators not to submit proprietary or confidential information.

--By David Metzger, Kristen Ittig, Caitlin Cloonan, Kristen Riemenschneider and Steffen Jacobsen, Arnold & Porter LLP

David Metzger and Kristen Ittig are partners in Arnold & Porter's Northern Virginia office. Caitlin Cloonan is counsel and Kristen Riemenschneider is an associate in the firm's Northern Virginia office. Steffen Jacobsen is an associate in the firm's Washington, D.C., office.

[1] SBA Small Business Size Regulations, SBIR Program and STTR Program, 77 Fed. Reg. 28,520-28,530 (May 15, 2012) (to be codified at 13 C.F.R. Part 121).

[2] P.L. 112-81 at Division E, as codified at 15 U.S.C. § 638 (2011).

[3] P.L. 102-564, as codified at 15 U.S.C. § 638 (1992).

[4] Congress mandated final rulemaking on all aspects of the act within one year.

[5] 77 Fed. Reg. at 28,521.

[6] See 13 C.F.R. § 121.105(a)(1) ("[A] business concern eligible for assistance from SBA as a small business is a business entity organized for profit, with a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S. economy through payment of taxes or use of American products materials or labor.").

[7] See generally act, § 5107(c)(3)(D).

[8] 13 C.F.R. § 121.702.

[9] 13 C.F.R. § 121.103.

[10] The proposed rule would also change the SBA officials who may initiate size protests, substituting the associate administrator, Investment Division and director, Office of Government Contracting for the previously named SBA officials.