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SBA's Final SBIR/STTR Eligibility Rule: A Safer Harbor for SBIR Financing

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Presented: March 13, 2013
CIT Advanced SBIR Workshop
Herndon, Virginia

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Summary of SBA's Final SBIR/STTR Eligibility Rule

- The Final rule, among other things:
 - Eliminates the reference to the controversial "domestic business concern" definition
 - Makes the time of size determinations SBIR and STTR firms the time of award, not time of proposal submission
 - Makes the VCOC/hedge fund/private equity group eligibility provisions applicable *only* to SBIR firms – not STTR firms
 - Established an SBIR/STRR-specific affiliation rule
 - Prohibits Investment Companies from owning in excess of 50% of SBIR firms
 - Allows Investment Company ownership of less than 40% of SBIR firms without affiliation (which could occur by other means)
 - Firms that are majority-owned by Investment Companies must register with SBA
 - Allows size protests by SBA or contracting officers *before* or *after* award

No More "Domestic Business Concerns"

- In the Proposed Rule, SBA stated SBIR/ STTR Phases I and II eligibility in terms of a new "domestic business concern" definition.
 - The "domestic business concern" approach allowed for foreign ownership of SBIR/STTR firms and was controversial and confusing.
- In the Final Rule, SBA completely eliminated the "domestic business concern" definition.
- SBA explained that it would be unduly burdensome for small businesses to certify as to the ownership of their investment firms.

The New Final Eligibility Rule

- The Final Rule simplified SBIR eligibility for Investment Companies with interests in SBIR applicants.
- It requires Investment Companies (defined as hedge funds, private equity firms and venture capital operating companies (VCOCs)) to:
 - "Have a place of business located in the United States," or pay taxes in the U.S., and
 - "Be created or organized in the United States, or under the law of the United States or any State."
- This definition applies to Investment Companies, not SBIR firms, although SBIR firms should still inquire about their Investment Companies.

Investment Company Eligibility is SBIR Only

- The new rules for Investment Company eligibility apply *only to SBIR firms*, and not to STTR firms.
- This is a significant change from the Proposed Rule.
- SBA concluded that STTR money is already going to universities, and that allowing Investment Company eligibility would dilute the program for small businesses.
- Thus, the Final Rule contains separate eligibility criteria for SBIR (13 C.F.R. § 702(a)) and STTR firms (13 C.F.R. § 702(b)).

SBIR Size Eligibility

- Under the new rule, an SBIR/STTR firm is eligible for Phase I and II funding agreements if:
 - The concern is more than 50% directly owned and controlled by one or more individuals who are citizens of the United States or permanent resident aliens in the United States, and/or other business concerns, each of which is more than 50% directly owned and controlled by individuals who are citizens of the United States or permanent resident aliens in the United States, or any combination of these;
 - Is a joint venture consisting of firms which meet these requirements;
 - The concerns, together with its affiliates, do not have more than 500 employees; and
 - For SBIR firms only, no Investment Company owns more than 50% of the concern.

Rules Governing Investments in SBIR Firms

- Under the Final Rule:
 - An SBIR firm is eligible to receive Phase I and II awards if no single Investment Company owns more than 50% of it.
 - Thus, an SBIR firm is eligible to receive SBIR funding if it is owned 49% by a hedge fund, 49% by a VCOC and 2% by a private equity firm.
 - Additionally, SBA established a new 40% threshold for Investment Company investments – SBA will *not find affiliation* solely on the basis that a single Investment Company controls or has the power to control less than 40% of an SBIR firm.
 - This is calculated on a "fully diluted basis," taking all types of stock (or other ownership indicia) into consideration.

Rules Governing Investments in SBIR Firms (cont'd)

- This is consistent with SBA's attempt to establish "bright lines" under the Final Rules so that small concerns would not have to guess where a judge might find affiliation.
- The 50% and 40% rules are different.
- The 50% rule is a prohibition on Investment Companies ownership in an SBIR firm – a 50% or greater ownership will definitely result in affiliation and prohibit Phases I and II awards.
- The 40% rule, however, is a "safe harbor" – as long as a single Investment Company's ownership does not exceed 40%, SBA will not find affiliation *on that basis* alone.
- SBA may find affiliation, however, on the basis of other factors set forth in the new SBIR/STTR-specific affiliation rule.

The New Affiliation Rule

- SBA created a new affiliation rule that is specific only to the SBIR and STTR Programs.
- The new affiliation rule:
 - Contrasts with the current § 121.103 affiliation rule
 - Provides the 50% and 40% thresholds described above
 - Defines more explicitly the "identity of interest" rule, stating for instance that family members will be presumed to be affiliated only if they share "identical or substantially identical business or economic interests"
 - However, the term "identity of interest" specifically excludes investments by two or more Investment Companies in the same concern
 - The Final Rule defines a "newly organized concern" as one that has been actively operating for less than one year – a bright line difference with the current § 121.103 rule
 - The remainder mirrors in large part the current § 121.103 rule

Other Provisions – Registration

- The Final Rule also has some additional noteworthy provisions:
 - Requires registration with SBA for majority-owned applicants (more than 50% owned by Investment Companies)
 - Such registration is *not* a certification of affiliation or lack of it
 - Registration must be made *prior* to submission of initial Phase I and II proposals
 - Failure to register in a timely manner with SBA requires notification to the funding agreement officer on the date of award, and the firm can receive the award only if the award took longer than 90 days to make

Other Provisions – Size Status During Contract

- The Final Rule clarifies that the SBIR/STTR firm will be considered small throughout the term of the funding agreement with two exceptions:
 - In the case of merger, acquisition, or novation; or
 - When the funding agreement begins its sixth year.
- In both of the exceptions, the small business must re-certify its size either within 30 days of a merger becoming final or 120 days prior to the beginning of the sixth year of a funding agreement.
- The "long term contract" exception is unlikely – Phases I and II do not run for six years, and Phase III awards are not governed by the size standard.

Other Provisions – Time of Certification and Protests

- The Final Rule abandoned the Proposed Rule's requirement of certification of size at the time of proposal submission and continued the current rule of certifying size *at the time of award*.
- The Final Rule also clarified the size protest rules in a significant way:
 - Contracting officers and SBA can now protest a firm's size *before* or *after* award;
 - The Proposed Rule allowed such protests only *in anticipation of* such an award.

False Claims Act Liability

- The Final Rule also calls out the False Claims Act's penalty for false certification.
- It clarifies that liability for a false certification under the SBIR Act can subject a concern to a penalty of up to three times the total value of the funding agreement.
- This provision brings the penalties of the False Claims Act into the SBIR Program and conforms the SBIR Directive with existing case law (*See ex rel. Longhi v. Lithium Power Tech., Inc.*, 513 F. Supp. 2d 866, 889 (S.D. Tex. 2007)).
- This provision is a reminder to certify accurately and that the False Claims Act applies to the SBIR Program.

Summary of the New Rule

- SBA did well in listening to the many comments on the Proposed Rule and in scaling it back.
- To SBA's credit, the Final Rule is much improved over the Proposed Rule.
- It successfully creates some bright lines that did not exist previously, but preserves those parts of the Directive that have stood the test of time and did not require change.
- The limitations on agency funding for firms majority-owned by Investment Companies (25% for DOD, NIH, and NSF and 15% for all others) are contained in the August 6, 2012 Directive and not this one.
- SBA will continue to review comments on the Final Rule.

Implications of the New Rule

- The Final Rule provides greater clarity for investments by Investment Companies in SBIR/STTR firms.
- The "less than 40%" rule provides a safe harbor for equity investments, if no affiliation occurs in other ways.
- An affiliation rule dedicated to SBIR/STTR firms is well-intentioned and helps avoid some of the unreasonable aspects of the non-SBIR rule.
- The "totality of the circumstances test," preserved in the SBIR/STTR affiliation rule, may still allow for affiliation by "negative control" – which would undo much of the good done by the Final Rule – this remains to be seen.

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