

## E-ALERT | Government Contracts

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### REAUTHORIZATION OPENS UP SBIR FUNDS TO SMALL BUSINESSES WITH VENTURE CAPITAL, HEDGE FUND, OR PRIVATE EQUITY BACKING

#### INTRODUCTION

On December 31, 2011, President Obama signed into law the National Defense Authorization Act for Fiscal Year 2012 (H.R. 1540), which, among other things, reauthorized the Small Business Innovation Research (“SBIR”) Program through September 30, 2017.<sup>1</sup> As detailed below, this legislation provides long-term certainty for small businesses hoping to take advantage of the federal grant program, increases the amount of funding available per grant, enlarges the amount of grant funds that agencies must set aside for inclusion in the program, and opens the door to certain small businesses that are owned in substantial part by venture capital operating companies, hedge funds, or private equity firms. These small businesses had previously been barred from participating in the Program.

#### SBIR PROGRAM BACKGROUND

The SBIR Program originated with the Small Business Innovation Development Act of 1982<sup>2</sup> and was designed to enable domestic small businesses to participate in research and development of innovative technical ideas that have commercialization potential. Eleven federal agencies,<sup>3</sup> *i.e.*, those with an extramural R&D budget that exceeds \$100 million, participate in the SBIR program and are therefore required to set aside a percentage of their extramural R&D budget for SBIR grants. Offering agencies specify a topic or technical area they wish to explore and then solicit proposals for developing that idea from qualifying businesses.

The SBIR process proceeds in three phases, but grant funds are available only for Phases I and II. In Phase I, funds are awarded to help businesses demonstrate the technical merit, workability, and commercial viability of their proposals; the standard grant period is relatively short, usually less than six months. Phase II grants are available only to Phase I awardees, are made on the basis of the technical merit and commercial viability of the Phase I work, and are used to further develop the R&D conducted in Phase I. Phase II grants are larger and longer than Phase I grants, usually lasting up to two years. In Phase III (which is not funded by SBIR grants), businesses pursue commercialization of the ideas or technology developed in Phases I and II.

The program is open only to domestic, for-profit small businesses with 500 or fewer employees. They must also be majority-owned by one or more U.S. citizens. Until the passage of H.R. 1540, this

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<sup>1</sup> H.R. 1540, Div. E.

<sup>2</sup> Pub. L. No. 97-219, 96 Stat. 217.

<sup>3</sup> The participating agencies are the Departments of Agriculture, Commerce (including both the National Institute of Standards and Technology and the National Oceanic and Atmospheric Administration), Defense, Education, Energy, Health and Human Services (including the National Institutes of Health (“NIH”)), Homeland Security, and Transportation, as well as the EPA, NASA, and the National Science Foundation (“NSF”).

last requirement was interpreted to mean that a business could not receive SBIR funds if one or more business entities (e.g., a venture capital operating company) owned 50% or more of the small business. This had the odd effect of failing to encourage innovation by small businesses that had already shown sufficient potential for developing commercially viable ideas to attract private-sector investment.

## SUMMARY OF THE SBIR REAUTHORIZATION

H.R. 1540 eliminated the total ban on SBIR participation by small businesses with venture capital, hedge fund, or private equity backing. Instead, it authorizes participation by small businesses that are (1) majority-owned by (2) multiple venture capital operating companies, hedge funds, or private equity firms. For example, if two venture capital firms each own minority stakes in a small business, and the combination of those minority stakes would amount to a majority interest, the small business is no longer barred from participating in the SBIR Program. However, if only a single venture capital, hedge fund, or private equity firm owns a majority stake in the small business, it still may not apply for SBIR funds.

The new law authorizes NIH, NSF, and the Department of Energy to allocate up to 25% of their SBIR funds for such awards, whereas other participating agencies may allocate only up to 15% of their SBIR budgets for such grants. The balance of agency SBIR funds will thus continue to be subject to the 51 percent individual ownership rule. Addressing concerns that individual agencies might direct funds away from small businesses owned by private equity firms, hedge funds, or venture capital firms, the legislation forbids agencies from using the fact of such ownership as a criterion in making SBIR awards.

The bill also makes several other noteworthy changes to the SBIR program, including:

- Raising the guidelines for grant sizes to \$150,000 for Phase I grants and \$1 million for Phase II awards, and providing for annual inflation adjustments;
- Allowing agencies to issue a second Phase II award to the same proposal;
- Increasing the size of the required agency set-aside from the current level of 2.5% of the agency's extramural R&D budget to 3.2% by 2017;
- Shortening the agencies' decision-making period to 90 days; and
- Expediting the release of funds once an award has been made.

The Small Business Administration ("SBA") has in the past resisted calls to change its SBIR eligibility rule to allow venture capital, hedge fund, and private equity ownership, but the new statute directs the SBA to draft regulations that will ensure full implementation of the new eligibility and set-aside requirements. The regulations must provide size standards for these SBIR applicants, as well as guidelines for determining whether a small business is affiliated with the hedge funds, venture capital operating companies, and private equity firms that own it. These guidelines will also address whether a small business is affiliated with other portfolio companies of its owner firms. The SBA must issue proposed rules for comment within 120 days and interim or final regulations within a year of the law's passage.

## CONCLUSION

The SBIR reauthorization opens the Program to a significant subset of small businesses with venture capital, hedge fund, or private equity backing. While significant budget restrictions remain, and competition for scarce federal dollars will always be stiff, this legislation should provide an important

tool for these small businesses to obtain additional funding for R&D, especially at the very early stages of project development.

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Attorneys at Covington & Burling LLP are experts in advising companies on matters relating to government contracts and grants, including the SBIR Program, as well as rulemaking proceedings by the SBA and other agencies. We are closely monitoring the SBA's progress and would be pleased to discuss the proposed, interim, and final rules when they are issued, as well as help formulate comments that will alert the SBA to costs and benefits of its proposal for your particular type of business.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our government contracts practice group:

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