

SBIR COMPETITION ELIGIBILITY FOR VENTURE CAPITAL OWNED/CONTROLLED BUSINESSES

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There is significant mis-information and disinformation circulated regarding SBIR competition eligibility for businesses that are owned and/or controlled by venture capital organizations. This note aims to lay out the facts on the issue.

1. Current SBA SBIR Policy Directive Rules

The SBA SBIR Policy Directive (PD) is a set of rules governing administration of the SBIR Program. SBA is mandated by congress to issue the document. The current PD was published in the Federal Register 24 Sep 2002.

Section 3(y) of the PD defines the requirements for a small business concern (SBC) to be eligible for SBIR competition:

3(y) *Small Business Concern (SBC)*. A concern that, on the date of award for both Phase I and Phase II funding agreements:

(1) is organized for profit, with a place of business located in the United States, which operates primarily within the United States or which makes a significant contribution to the United States economy through payment of taxes or use of American products, materials or labor;

(2) is in the legal form of an individual proprietorship, partnership, limited liability company, corporation, joint venture, association, trust or cooperative, except that where the form is a joint venture, there can be no more than 49 percent participation by foreign business entities in the joint venture;

(3) is at least 51 percent owned and controlled by one or more individuals who are citizens of, or permanent resident aliens in, the United States, except in the case of a joint venture, where each entity to the venture must be 51 percent owned and controlled by one or more individuals who are citizens of, or permanent resident aliens in, the United States; and

(4) has, including its affiliates, not more than 500 employees.

Section 3(y)(3) above is the key part of the definition of a SBC that bears on the VC SBIR eligibility issue. The highlighted part states that the SBC must be 51 percent owned and controlled by *individuals*... In addition, of course, SBIR eligibility requires compliance with the other rules, including item (4) that the SBC and all its affiliates have not more than 500 employees.

Hence, any subsidiary of a parent business currently is ineligible for SBIR competition (whether or not the parent is an SBC that is itself eligible for SBIR competition). Several small businesses have challenged the 51% ownership by *individuals* with the SBA Office of Hearings

and Appeals (OHA). However, the OHA has consistently held that “individual” means natural person, and has upheld the 51% ownership by individual rule. Examples may be found at the links below.

<http://www.sba.gov/oha/allcases/sizcases/SIZ4423.txt>

<http://www.sba.gov/oha/allcases/sizcases/siz4560.txt>

<http://www.sba.gov/oha/allcases/sizcases/siz4567.txt>

A key case that drove the present VC/BIO push for VC eligibility is the first listed above (Cognetix, SIZ4423). Cognetix (located in Utah) filed additional appeals, and engaged Senator Bennett (R-UT), VC associations, and the BIO organization in the pursuit to change the SBIR eligibility rules.

2. SBA Proposed Rule Change to Allow Subsidiary Eligibility

SBA proposed to change Section 3(y)(3) above to allow SBIR eligibility for subsidiaries of parents that are themselves eligible for SBIR competition. In the 4 Jun 2003 issue of the Federal Register (pages Page 33412-33416), the SBA proposed to add the following language to Section 3(y)(3):

“or (2) A for-profit business concern that is 100% owned by another for-profit business concern, as defined in Sec. 121.105, that is itself at least 51% owned and controlled by one or more individuals who are citizens of the United States, or permanent resident aliens in the United States.”

The term “100%” in the language above was replaced by “more than 50%” in the final rule change submitted to the Office of Management and Budget as explained below in this section.

The proposed rule change would make it possible for such subsidiaries to receive SBIR awards by extending eligibility to for-profit business concerns that are owned or controlled by a single other for-profit business concern that is itself at least 51% owned and controlled by one or more individuals who are citizens of the United States or permanent resident aliens in the United States; provided that the subsidiary, together with the parent firm and its affiliates, employ no more than 500 people.

Under the proposed rule, a small business owned and/or controlled by a VC firm would be eligible for SBIR awards so long as the VC firm meets the small business size standard for program eligibility (i.e., is more than 51% owned and controlled by one or more individuals who are citizens of the United States, or permanent resident aliens in the United States; and has, together with all of its affiliates including the SBIR applicant, no more than 500 employees).

The implication of the proposed rule change for VC involvement is the same as for any other type of firm: it would allow (venture capital and other) firms **that qualify as small businesses** to own companies that receive SBIR funds.

The rule change would leave unchanged the long-standing requirements concerning minority holdings in SBIR awardees: VC firms, other institutional investors, and corporations, regardless of their size, may all invest in and own part of an SBIR awardee firm as long as such

investments do not exceed 49 percent of the SBIR firm, or enable these investors to have power to control the company.

On approximately 22 Dec 2003, SBA approved the rule change, and sent it to the Office of Management and Budget (OMB) for final approval. The final rule change language adjusted the ownership and control of the subsidiary by the parent company from "100%" to "more than 50%," thus allowing more small businesses (including those owned and controlled by VC firms) an opportunity to participate in the SBIR program.

Unfortunately, on about 23 Mar 2004, OMB returned the proposed rule change to SBA without approving it. In addition, SBA was instructed to review the document further and hold additional discussions with the VC community. So now, the old rule (51% ownership by individuals) continues to apply.

3. S.2384 and H.R.4149 Aimed at Allowing VC SBIR Eligibility

On 5 May 2004, Senator Bond (R-MO) along with Senators Snowe (R-ME) and Kennedy (D-MA) introduced S.2384 that aimed at overruling the provisions of the SBA SBIR Policy Directive provisions on SBIR eligibility discussed above. H.R.4149 was introduced 2 Apr 2004 and has virtually the same language as S.2384.

The specific language of S.2384 and H.R.4149 is as follows:

- (a) IN GENERAL- Section 9(f) of the Small Business Act (15 U.S.C. 638(f)) is amended by adding at the end the following:
 - `(4) ELIGIBILITY- A business concern shall not be prevented from participating in the Small Business Innovation Research Program solely because such business concern is owned in part by--
 - `(A) a venture capital operating company that is managed and controlled by 1 or more United States citizens or permanent resident aliens; or
 - `(B) an employee benefit or pension plan.'.

- (b) RULEMAKING AUTHORITY- Not later than 180 days after the date of enactment of this Act, the Administrator of the Small Business Administration shall issue regulations to--
 - (1) carry out the amendment made by subsection (a);
 - (2) ensure that a Small Business Innovation Research award is not given to a business concern that is majority owned by--
 - (A) another business concern that is ineligible to participate in the Small Business Innovation Research Program; or
 - (B) a venture capital operating company or an employee benefit or pension plan that is the alter ego, instrumentality, or identity of another business concern that is ineligible to participate in the Small Business Innovation Research Program.

The changes proposed by S.2384/H.R.4149 clearly would allow businesses controlled by large VC firms to be eligible for SBIR competition, and would favor regions with a higher incidence of VC activity. A major concern of opponents to the measure is that the change represents a foot-in-the-door and only the tip of the iceberg of future changes that would be sure to come. This is

viewed as unhealthy for the integrity of the SBIR Program and for small businesses, especially in regions that under participate in the SBIR Program (e.g., rural regions).

4. A Proposed Compromise

First, before any changes to the SBIR Program are enacted into law, full and open hearings must be held by Congressional committees with jurisdiction over the SBIR Program (Senate Committee on Small Business and Entrepreneurship, and House Committees on Small Business and Science). This has been the procedure followed on all SBIR reauthorizations in the past. SBIR Program changes as substantial as those proposed by S.2384/H.R.4149 should not be enacted without all their pros and cons of being heard from both sides of the issue.

Second, a reasonable compromise would be to enact by statute the proposed rule change described in Section 2 above. This proposed change received public comment, and was approved by SBA for implementation but returned to the SBA by the OMB with instructions to review the document further and hold additional discussions with the VC community. As cited in Section 2 above, this change would allow businesses owned and/or controlled by VC firms to qualify for SBIR competition if the VC firm itself meets the eligibility criteria. At the same time, it would keep businesses owned by large VC firms ineligible for SBIR competition, and protect the long-term integrity of the SBIR Program.