



# GAO Weakens the SBIR Phase III Preference

Decision narrowly construes the scope of a special acquisition preference afforded to SBIR participants.



BY STEPHEN L. BACON

**T**he Small Business Innovation Research (SBIR) program was established in 1982 to help small businesses perform research and development work on technology that has the potential for commercialization. For more than a decade, Congress has required agencies to afford a special acquisition preference to SBIR participants when making “Phase III awards.”

Phase III work is defined to include any “work that derives from, extends,

or completes efforts” by the SBIR participant in Phases I and II of the program.<sup>1</sup> The Small Business Act provides that federal agencies, “to the greatest extent practicable,” are required to “issue, without further justification, Phase III awards relating to technology, including sole source awards, to the SBIR and [Small Business Technology Transfer (STTR)] award recipients that developed the technology.”<sup>2</sup>

This unique acquisition preference

is afforded to SBIR participants in recognition of their competitive selection for awards in Phases I and II. It is also intended to promote the commercial success of their SBIR-derived technology.<sup>3</sup>

Despite this strong congressional mandate, many SBIR participants have expressed concern that agencies are not implementing the preference in a way that is consistent with the law and the overarching policy goals of the SBIR program.

Earlier this year, in the protest of *PublicRelay*, the Government Accountability Office (GAO) held that agencies are not required to issue a Phase III award unless they are specifically seeking to acquire a firm's SBIR-derived technology.<sup>4</sup>

According to GAO, the Phase III preference is not mandatory where an agency issues a competitive solicitation and a SBIR participant could use its SBIR-derived technology to satisfy the agency's requirement. This ruling will likely make it more difficult for SBIR participants to leverage the Phase III preference to obtain contracts for their technology.

### Phase III Preference Background

Agencies are required to reserve a portion of their research and development (R&D) funds for awards to small businesses under the SBIR program, which has three phases. In Phase I, small businesses conduct research on a general topic outlined in the agency's SBIR program solicitation.<sup>5</sup> Phase I awardees may submit proposals for further development work on the topic to be performed in Phase II.<sup>6</sup>

A firm that participated in Phases I or II is eligible for a Phase III agreement. Agencies use non-SBIR funding to make Phase III awards, and the law places "no limit on the number, duration, type, or dollar value of Phase III awards."<sup>7</sup>

There is also no limit on the time that may elapse between a Phase I or Phase II award and a follow-on Phase III award.<sup>8</sup> And, importantly, a company does not need to qualify as

a small business concern to receive a Phase III award.

The Phase III preference was originally codified under the SBIR/STTR Reauthorization Act of 2011. The initial preference provision stated: "To the greatest extent practicable, federal agencies and federal prime contractors shall issue Phase III awards relating to technology, including sole source awards, to the SBIR and STTR award recipients that developed the technology."<sup>9</sup>

### Protest of Toyon Research Corporation

In 2014, GAO addressed the Phase III preference requirement for the first time and narrowly construed the definition of a Phase III award in the protest of *Toyon Research Corporation*.<sup>10</sup> In that case, the protester argued that it was entitled to Phase III preference for the Army's development of a distributed aperture satellite communications system for on-the-move vehicular applications.

The protester had previously performed research and development work on this topic pursuant to SBIR awards in Phases I and II. However, the Army later issued a competitive Call for Proposals (CFP) issued under a Broad Agency Announcement related to this topic and did not give the protester Phase III preference.

The protester argued that it deserved the preference because the CFP "derives from, extends, or completes" the work it performed in Phases I and II for nearly identical system requirements. GAO denied the protest, however, and held that the similarity between the requirements

in Phases I and II and the Army's new requirements "does not demonstrate that the CFP effort derives from, extends, or completes the SBIR effort."<sup>11</sup>

GAO concluded that an agency's new solicitation does not constitute a Phase III unless the agency's requirements "are refined by incorporating original concepts, findings, ideas, or research results that a contractor generated through performance of a contract" awarded in prior SBIR phases.<sup>12</sup> GAO found that the CFP was not a Phase III because it did not include any requirements that were "reasonably identifiable as original concepts, findings, ideas, or research results" generated during its prior SBIR work.<sup>13</sup>

Notably, GAO reached this conclusion even though the Small Business Administration (SBA), the agency responsible for administering the SBIR program, agreed with the protester. In the SBA's view, the protester "demonstrated the feasibility of a unique approach to meeting the requirement in the CFP, and, therefore, the CFP derives from, extends, or completes [its] SBIR work."<sup>14</sup>

### Phase III Preference Amendments

In the National Defense Authorization Act (NDAA) for Fiscal Year 2018, Congress amended the Small Business Act and made changes to the Phase III preference requirement. The statute, as amended, now provides:

(4) Competitive procedures and justification for awards. To the greatest extent practicable, federal agencies and federal prime contractors shall –

(A) consider an award under the SBIR program or the STTR program to satisfy the requirements under section 2304 of title 10, United States Code, and any other applicable competition requirements; and (B) issue, without further justification, Phase III awards relating to technology, including sole source awards, to the SBIR and STTR award recipients that developed the technology.

15 U.S.C. § 638(r)(4).

The SBA subsequently amended its SBIR/STTR Policy Directive (“Policy Directive”) in 2019 to implement this amendment and other changes through notice and comment rulemaking.<sup>15</sup>

Regarding the Phase III preference, the SBA explained that “[t]his provision addresses the concern that, at times, agencies have failed to use this authority, bypassed the small business that created the technology, and pursued the Phase III work with another business rather than actively supporting and encouraging the commercialization or further development of SBIR/STTR technology by the innovative small business that developed the technology.”<sup>16</sup>

The SBA made changes to its Policy Directive to ensure that agencies follow the Phase III preference. For example, the Policy Directive requires agencies to document a decision not to afford Phase III preference and to provide that justification to the SBA.<sup>17</sup> The Policy Directive also includes a process for SBA to appeal such a decision on behalf of the small business.<sup>18</sup>

### Protest of PublicRelay

Earlier this year, GAO issued its

most recent decision addressing the Phase III preference requirement in *PublicRelay*.<sup>19</sup> Beginning in 2011, PublicRelay developed media analysis software under SBIR Phase I and II contracts with the National Science Foundation. After learning about the SBA’s requirement for news briefing services, PublicRelay contacted the SBA to express interest in responding to a solicitation and performing the work as a Phase III award.

Ultimately, however, the SBA decided to use the General Services Administration (GSA) schedule to fulfill its requirement. PublicRelay was not eligible to compete for the SBA’s requirement because PublicRelay’s software was not available on the GSA schedule.

The SBA concluded that the requirement was not Phase III work because it was unaware of the protester’s prior SBIR work when it drafted the requirement. Also, the SBA did not require PublicRelay’s specific technology. And finally, the requirement did not incorporate any of PublicRelay’s original concepts, findings, ideas, or research results. The SBA made this determination even though it conceded that PublicRelay could use its SBIR-developed software to perform the SBA’s requirement for news briefing services.

PublicRelay filed a GAO protest challenging the SBA’s decision to procure its requirement under the GSA schedule instead of negotiating a Phase III sole-source contract with PublicRelay. PublicRelay argued that it should have been given Phase III preference because performing the

SBA’s requirement would “extend” its efforts under prior SBIR awards.

GAO denied the protest and agreed with the SBA that it was not required to award PublicRelay a sole-source Phase III contract. GAO explained that the SBA’s requirement did meet the Policy Directive’s definition of Phase III work, which includes “SBIR/STTR-derived products or services” as one type of activity that constitutes Phase III work. As a result, GAO concluded that the SBA was *permitted* to award a sole-source Phase III contract to meet its requirement with PublicRelay’s SBIR-derived software.

However, GAO agreed with the SBA that it was not required to award a Phase III contract to PublicRelay under these circumstances. GAO adopted the SBA’s position that the Policy Directive “affords agencies the discretion to pursue SBIR phase III awards and mandates an SBIR phase III award only in certain circumstances.”<sup>20</sup>

Under this interpretation, an agency may award a Phase III contract to a firm that can use its SBIR-developed technology to meet the agency’s needs. But the mandatory “special acquisition requirement applies only when an agency seeks the specific technology developed by the SBIR awardee under its prior awards.”<sup>21</sup>

As GAO explained, “where the agency is not specifically pursuing the production of technology developed under a prior SBIR phase I or II award, an agency has the discretion to fund such efforts only if it elects to do so.”<sup>22</sup>

Regarding its prior decision in *Toyon*, GAO noted that the test it

applied in that case was not adopted in subsequent amendments to the Small Business Act and the Policy Directive.<sup>23</sup> As a result, GAO indicated that “Toyon may have been superseded” but it ultimately concluded that it “need not resolve that issue” to decide PublicRelay’s protest.<sup>24</sup>

### Discretionary vs. Mandatory Phase III Awards

GAO’s distinction between “discretionary” and “mandatory” Phase III awards is based on language in the Policy Directive. The source of the “discretionary” Phase III award states: “An agency that wishes to fund an SBIR/STTR Phase III award, which is an extension of prior Phase I and/or Phase II awards, is not required to conduct another competition for the Phase III award in order to satisfy those statutory provisions.”<sup>25</sup> On the other hand, the Policy Directive’s provision that addresses the “special acquisition preference” states that it applies when an agency decides to “pursue R/R&D or production of technology developed under the SBIR/STTR program shall issue Phase III awards relating to the technology.”<sup>26</sup>

Although the Policy Directive may provide some basis for the interpretation adopted by GAO and the SBA, the distinction between “discretionary” and “mandatory” Phase III awards is not firmly rooted in the governing statute. As discussed above, the law provides that agencies shall issue “Phase III awards relating to technology, including sole source awards, to the SBIR and STTR award recipients that developed the technology.”<sup>27</sup>

The statute could be interpreted to mean that the Phase III preference applies whenever an agency seeks work that “relates” in some way to the technology developed under a prior SBIR award. This reading of the Phase III statutory preference aligns with the Policy Directive’s statement that, “[a]gencies must make a good faith effort to negotiate with [SBIR] Awardees regarding the performance of the new, *related*, work and to issue Phase III awards for the work.”<sup>28</sup> These interpretive issues could be raised in future cases that address the Phase III preference. This includes cases at the Court of Federal Claims, which has not yet opined on the meaning of the Phase III preference.

### Conclusion

The Phase III acquisition preference provides an enormous opportunity for SBIR participants to grow and market their technology to federal agencies. The *PublicRelay* decision makes clear that agencies have the discretion to leverage this preference and award sole-source contracts to acquire SBIR-derived technology.

In practice, however, many SBIR participants have been disappointed by the lack of opportunities for Phase III awards. GAO’s decision will likely make it harder for SBIR participants to “force” an agency to apply the Phase III preference. SBIR participants may continue to face obstacles to obtaining Phase III awards unless Congress, the SBA, or future court decisions adopt a more expansive view of the Phase III preference. **CM**

*The views expressed in this article are those of the author and do not necessarily reflect the views of Rogers Joseph O'Donnell or its clients. This article is for general information purposes and is not intended to be and should not be construed as legal advice.*

**Stephen L. Bacon** is a shareholder in the Washington, D.C. office of the law firm Rogers Joseph O'Donnell, where he represents government contractors in bid protests, claims, investigations, and suspension and debarment proceedings. He frequently litigates cases at the Court of Federal Claims, the Government Accountability Office, the Boards of Contract Appeals, and the Small Business Administration’s Office of Hearings and Appeals. He also provides advice and counseling to clients on a broad range of contractual and regulatory compliance issues that confront government contractors.

### ENDNOTES

- 1 15 U.S.C. § 638(e)(4)(C).
- 2 15 U.S.C. § 638(r)(4). The Phase III preference applies to both the SBIR and STTR programs. For ease of reference, this article refers to the SBIR program because it is the larger and more influential than the STTR program.
- 3 Policy Directive, § 4(c)(7)(i).
- 4 *PublicRelay*, B-421154; B-421154.2, Jan. 17, 2023, 2023 CPD ¶ 28.
- 5 15 U.S.C. § 638(e)(4)(A).
- 6 15 U.S.C. § 638(e)(4)(B).
- 7 Policy Directive, § 4(c)(5); 15 U.S.C. § 638(e)(4)(C)(ii).
- 8 Policy Directive, § 4(c)(5).
- 9 15 U.S.C. § 638(r)(4) (2011).
- 10 *Toyon Research Corp.*, B-409765, Aug. 5, 2014, 2014 CPD ¶ 235.
- 11 *Id.* at 9.
- 12 *Id.* at 11.
- 13 *Id.*
- 14 *Id.* at 16, n.15.
- 15 84 Fed. Reg. 12794 (Apr. 2, 2019).
- 16 84 Fed. Reg. at 12802.
- 17 Policy Directive, § 4(c)(7)(iv).
- 18 *Id.* § 4(c)(7)(v).
- 19 *PublicRelay*, 2023 CPD ¶ 28.
- 20 *Id.* at 7.
- 21 *Id.* at 8.
- 22 *Id.* at 9.
- 23 *Id.* at 9, n.7.
- 24 *Id.*
- 25 Policy Directive, § 4(c)(3).
- 26 *Id.* 4(c)(7).
- 27 15 U.S.C. § 638(r)(4).
- 28 Policy Directive, § 4(c)(7)(i).