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Stay in Control

Participants in the Small Business Innovation Research (SBIR) program must know how to navigate the negative control and ostensible subcontractor rules to maintain eligibility.

BY STEPHEN L. BACON

In the last several years, venture capital firms have become increasingly interested in backing small businesses that can deliver innovative technologies to the federal government. The Department of Defense (DoD) is especially interested in attracting investment to support small businesses that can help deliver cutting-edge technologies to the warfighter.

Many participants in the Small Business Innovation Research (SBIR) program are potential targets for venture capital investment. The SBIR program provides funding for small business to perform research and development (R&D) work on their technologies.

R&D funding provided through the SBIR program can be a game-changer for small firms that are looking to break into the federal market, but to take advantage of these benefits small businesses and the companies that invest in or collaborate with them must understand the special eligibility rules that apply to the SBIR program.

SBIR participants are required to meet strict ownership, control, size and affiliation rules established by the Small Business Administration (SBA).[1] In general, an SBIR awardee must be more than 50% owned and controlled by United States citizens or permanent residents aliens of the United States, other small business concerns that are more than 50% directly owned and controlled by individuals who are U.S. citizens or permanent resident aliens of the United States, or any combination of these.[2] Moreover, the SBIR awardee and its affiliates may not have more than 500 total employees.[3] Two businesses are affiliated when one business either controls or has the power to control the other business.[4]

In addition to these basic requirements, there are other lesser-known rules that can impact a firm's eligibility for an SBIR award when they bring on outside investors or team with subcontractors. The rules pertaining to "negative control" and "ostensible subcontractors" create especially dangerous affiliation traps that firms must avoid to remain eligible for SBIR awards.

Negative Control

An investment firm that takes a minority stake in a small business must balance competing priorities. Investors want to protect their investment by securing the right to participate in some aspects of managing the company. However, an investment firm's right to participate in or block certain management decisions can result in a finding of affiliation that renders the small business ineligible for an award.

There are various ways in which the SBA can find affiliation between two firms. For example, affiliation may arise where the investor directly controls the majority of seats on the board of directors.[5] Minority investors are unlikely to obtain this type of direct, "affirmative" control over the small business.

Instead, minority investors are more likely to obtain "negative" control over certain day-to-day management actions. The SBA Office of Hearings and Appeals (OHA) has ruled "that the existence of veto power over an important aspect of business constitutes negative control."[6]

Even if the investor does not actually exercise negative control, the mere right of the investor to veto important decisions can result in a finding of affiliation. The SBA's general affiliation principles define negative control to include "instances where a minority shareholder has the ability, under the concern's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders."[7]

In addition to preventing a quorum or blocking actions by the board, SBA OHA has concluded that veto power over other day-to-day decisions regarding the operation and management of the firm can constitute negative control. This includes, for example, changing the company's budget, incurring debt, purchasing equipment, hiring and firing officers, and setting employee compensation, among other actions.[8]

While minority investors cannot veto these "ordinary actions," the SBA does permit them to block certain "extraordinary actions" that are not essential to the firm's daily operations. For example, "selling or otherwise disposing of all of the firm's assets, admitting new members, amending the operating agreement in any manner that materially alters the rights of existing members, or filing for bankruptcy all constitute extraordinary actions that may require the minority shareholder's input, but do not create negative control."[9]

In the SBA's view, a minority investor's control over "extraordinary actions" is permissible because the investor's power is designed to protect their investment and does not constitute control over the ordinary actions of the business.

To maintain eligibility for award, small businesses and their outside investors must carefully craft the agreements governing the investors' rights to avoid an affiliation finding based on negative control. To the extent investors are granted any veto rights, they should be limited to "extraordinary actions" that do not encroach on the "ordinary actions" that impact the day-to-day management of the business.

Unfortunately, the SBA regulations do not contain a comprehensive list of "ordinary" and "extraordinary" actions and these concepts continue to evolve through SBA OHA case law. Small businesses and investors should stay apprised of developments in this area to be sure their agreements comply with the SBA's affiliation rules.

Ostensible Subcontractor Rule

It is common for large businesses to perform subcontractor work under an SBIR award. In fact, large businesses often use SBIR agreements as a way to learn more about smaller firms that may be targets for a future acquisition. By participating in SBIR agreements, larger firms can also form strategic relationships with SBIR awardees that can be leveraged for other programs and opportunities.

When teaming for an SBIR award, firms must appropriately structure their relationship to avoid a finding of affiliation under the ostensible subcontractor rule. Under that rule, a small business concern and its "ostensible subcontractor" are treated as joint venturers and, therefore, they are affiliated for size determination purposes and must meet the ownership and control requirements applicable to joint ventures.[10]

SBA regulations define an "ostensible subcontractor" as "a subcontractor or subgrantee that performs primary and vital requirements of a funding agreement (i.e., those requirements associated with the principal purpose of the funding agreement), or a subcontractor or subgrantee upon which the concern is unusually reliant."[11]

If a firm's eligibility for award is challenged under the ostensible subcontractor rule, the SBA will consider "[a]ll aspects of the relationship between the concern and subcontractor" including "the terms of the proposal (such as management, technical responsibilities, and the percentage of subcontracted work) and agreements between the concern and subcontractor or subgrantee (such as

bonding assistance or the teaming agreement).”[12]

The small business awardee is generally required to perform a minimum of two-thirds of the “research or analytical effort” for Phase I and a minimum of one half of that effort for Phase II.[13] Further, the small business must employ the project manager/principal investigator (PI) for the award.[14]

The proposal and any teaming agreement between the small and large business must be written with these requirements and the ostensible subcontractor rule in mind. It is especially important to document the commitment of the small business to perform the primary and vital requirements including its minimum share of the research and analytical effort. A failure to do so can result in a finding of ostensible subcontractor affiliation.

This occurred in the Size Appeal of NFRL LLC, a case that involved two SBIR Phase II grant awards issued by the U.S. Special Operations Command for a Next Generation Sniper Display and a Long-Range Machine Gun Sight.[15] The SBIR awardee, NFRL, intended to use Lightforce USA, Inc. as its subcontractor.

The contracting officer (CO) filed a size protest against NFRL due to concerns about the relationship between NFRL and Lightforce. The cognizant SBA Area Office scrutinized the ties between NFRL and Lightforce and concluded that they were affiliated on several grounds, including under the ostensible subcontractor rule.

In that regard, the SBA found that NFRL intended to rely on Lightforce to perform the primary and vital requirements of the grants including performing research, breadboard testing, and prototype assembly.[16] NFRL’s price proposal also showed that labor provided by Lightforce engineers would account for “approximately 64-66% of the total base year costs.”[17]

After reviewing these facts, the Area Office concluded that NFRL would not have received the grants “without the employees, past performance, and technical approach” of its proposed subcontractor.[18] As a result, NFRL and Lightforce were deemed affiliated under the ostensible subcontractor rule, a determination that was upheld by OHA on appeal.[19] Moreover, NFRL and Lightforce could not qualify as an eligible joint venture because Lightforce was owned and controlled by an Australian citizen.[20]

Conclusion

The prospect of obtaining R&D funds through the SBIR program is extremely attractive to small businesses, their investors, and potential business partners. But companies that intend to participate in the SBIR program must proceed with caution when taking on outside investors or partnering with other firms to pursue SBIR opportunities.

The rules surrounding SBIR eligibility are complex and a violation can have devastating consequences. At a minimum, a firm’s non-compliance with SBA rules will preclude it from winning SBIR awards. A violation of SBA rules could also trigger potential liability under the False Claims Act, which may subject a firm to significant monetary damages or even criminal prosecution. To avoid these consequences, agreements with investors and potential subcontractors should be thoroughly vetted to ensure compliance with all of the SBA’s eligibility requirements including the negative control and ostensible subcontractor rules. **CM**

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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.

ENDNOTES

1 See generally 13 C.F.R. § 121.702.
2 13 C.F.R. § 121.702(a)(1)(i). A firm may also be eligible for an SBIR award if it is more than 50% directly owned and controlled by an Indian tribe, Alaska Native Corporation (ANC), or Native Hawaiian Organization (NHO) (or a wholly owned business entity of such tribe, ANC or NHO). Id.
3 13 C.F.R. § 121.702(c).
4 Id.
5 13 C.F.R. § 121.702(c)(3).
6 Cytel Software, Inc., SBA No. SIZ-4822, *6 (2006).
7 13 C.F.R. § 121.103(a)(3).
8 Southern Contracting Solutions III, LLC, SBA No. SIZ-5956, *11 (2018).
9 Id.
10 13 C.F.R. § 121.702(7).
11 Id.
12 Id.
13 See SBIR/STTR Policy Directive, § 6(a)(2).
14 Id. § 6(a)(3).
15 NFRL LLC, SBA No. SIZ-6174 (2022).
16 Id. at *5.
17 Id.
18 Id.
19 Id. at *8-10.
20 Id. at *10.