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FEATURE COMMENT: Buyers And Sellers Beware—A Merger Or Acquisition May Jeopardize SBIR Funding

U.S. merger and acquisition (M&A) activity in 2005 exceeded $1 trillion, a 33-percent increase over 2004, and reached the $1 trillion threshold for the first time since 2000. 10 No. 1 M&A Lawyer 1. According to ACG/Thompson's January 2006 DealMaker's Survey, 90 percent of the respondents thought that 2006 will be another strong year for M&A, particularly in the life-sciences area. One reason for the expectation of continued robust M&A activity in the life-sciences sector is an increasing perception among biotechnology companies that a merger or acquisition, as opposed to partnering, ultimately will generate improved product development and, therefore, lead to increased shareholder value. See *Pharma Marketletter* (Jan. 16, 2006).

For example, in late December 2005, Amgen agreed to acquire Abgenix, a company which recently had received favorable Phase III clinical trials data for a late-stage colorectal cancer therapy. According to published reports, before the acquisition, Amgen and Abgenix had a royalty sharing arrangement in place. Amgen apparently determined that acquiring the company in its entirety made more business sense than continuing with the shared royalty arrangement. Similarly, last year, Pfizer acquired two small biotechnology companies, Angiosyn Inc. and Bioren Inc., whose research focus aligned with Pfizer's own product-development goals.

The same business plan that drives large technology companies to acquire smaller firms also applies to M&A activity between smaller technology companies that believe a merger or acquisition will create synergies that will improve their product-development prospects. Many small technology companies that are acquisition targets of big businesses or that are combining among themselves often rely on grants under the Small Business Innovation Research (SBIR) program to fund their early-stage research and development activities.

Many players in the M&A world may not be aware that the eligibility rules for SBIR awards recently have become more restrictive and are the subject of significant attention in the research community, the Small Business Administration and Congress. This attention takes place in the broader spotlight of Congress' and agencies' increased scrutiny of companies that misrepresent their size status. See, e.g., Boston Globe, "Easing of Biotech Grant Limits Sought," March 24, 2006 (referencing tightened eligibility requirements since 2003). As a result, federal agencies that make SBIR awards closely monitor and examine eligibility status, and do not hesitate to deny new grants to a company whose status changes after a merger or acquisition.

This FEATURE COMMENT provides an overview of the SBIR program and its eligibility rules, analyzes how the SBA now interprets those rules and explains why both buyers and sellers should carefully evaluate their contemplated post-merger structure to determine whether the new entity will remain eligible to receive SBIR awards. If not, the value of a deal may be significantly impacted.

The SBIR Program—Congress established the SBIR program in 1982 through the enactment of the Small Business Innovation Development Act (SBIDA), P.L. 97-219. SBIDA requires specified agencies, including major sources of federal R&D dollars such as the department of Health and Human Services, Defense and Energy, and the National Science Foundation, to reserve a portion of their R&D budgets for awards to small businesses. Although the SBA sets overall guidance, each agency administers its own SBIR program and makes awards without SBA consultation or approval.

Congress enacted the SBIR program in response to what it perceived as reduced U.S. productivity,

relative to other industrialized nations, because of a "slowdown" in technological innovation. See S. Rep. No. 97-194, 97th Cong., 1st Sess. 1981, reprinted in 1982 USCCAN 512. Thus, the SBIR program's primary purpose is to increase federal R&D support available to innovative small businesses, thereby bolstering the competitive position of the U.S.

The SBIR program functions in three discrete phases. Phase I is considered the "start-up" phase and generally consists of small awards and relatively brief performance periods intended to support assessment of the technical merit and commercialization prospects for a particular concept or technology. Phase II funding is available only to Phase I awardees and consists of more significant support for an extended time. During Phase II, the awardee performs R&D work and continues to evaluate a concept's commercial potential. Phase III is the actual commercialization of the technology. Although referred to as Phase III, no SBIR funding is provided to support the awardee's efforts to move the technology from the laboratory to the marketplace.

Phase I and Phase II awards generally may not exceed $100,000 and $750,000, respectively. However, participating agencies may make larger awards if appropriate. A recent Government Accountability Office study examined SBIR awards from the two largest participating agencies—DOD and the National Institutes of Health—and confirmed that they make awards well above the statutory guidelines. See *Small Business Innovation Research: Information on Awards Made by NIH and DoD in Fiscal Years 2001 through 2004* (GAO-06-565) (April 2006). For instance, at NIH between Fiscal Years 2001 and 2004, Phase I awards averaged $162,537, ranging from $61,750 to $1.7 million. The average for Phase II awards was almost $200,000 above the guidelines at $934,643, and the awards ranged from $150,593 to $6.5 million. Similarly, at DOD, Phase I awards averaged $89,504 and reached $449,000, while Phase II awards averaged just slightly above the guidelines, at $771,362, but were as high as $4.2 million. Thus, SBIR revenue can quickly become a material component of a small company's R&D budget.

SBIR Eligibility—The current SBIR eligibility criteria are set forth in the SBA's size standards:

> (a) *Ownership and control.* (1) An SBIR awardee must (i) be a concern which is 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; or (ii) Be a concern which is at least 51% owned and controlled by another business concern that is itself at least 51% owned and controlled by individuals who are citizens of, or permanent resident aliens in the United States; or (iii) Be a joint venture in which each entity to the venture must meet the requirements set forth in either paragraphs (a)(1)(i) or (a)(1)(ii) of this section ....
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> (b) *Size.* An SBIR awardee, together with its affiliates, [may] not have more than 500 employees.

13 CFR § 121.702.

As reflected in the applicable size standard, the key concepts of SBIR eligibility are (1) ultimate 51-percent ownership and control by *individuals* who are U.S. citizens or permanent resident aliens, and (2) having 500 or fewer employees for the entity and its affiliates.

The application of the 500-employee standard to a combination of businesses is relatively straightforward. For example, a merger of two companies could easily put a newly formed company over the threshold, thereby making it ineligible for future SBIR awards. A more subtle aspect of this criterion is its reference to a company's "affiliates." The SBA views companies as being affiliated "when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists." 13 CFR § 121.103. Therefore a transaction that results in a large company exercising direct or indirect control over a SBIR awardee may also create an affiliation that, in certain circumstances, may render the subsidiary ineligible to receive new SBIR awards.

Unlike the 500-employee standard, which is relatively uncontroversial from a policy standpoint, the concept of ownership and control by "individuals" has evolved in recent years and remains a hotly contested issue.

The SBA's Interpretation of 'Individual'—When Congress implemented the SBIR program, it did not define a "small business" for the purpose of program eligibility. Instead, it directed the SBA to issue a policy directive to provide overall programmatic guidance for individual awarding agencies to follow. The SBA issued its first congressionally mandated SBIR Policy Directive, No. 65-01 on Nov. 24, 1982. The original SBIR size standard did not require 51 percent—or any other percentage—of

ownership or control by "individuals." Rather, a "small business" was simply defined as one that (a) "meets the size criteria for R&D and other regulatory requirements found in 13 CFR Part 121" (referring to the size standards applicable in most other SBA procurement programs, which are based on employee numbers or gross revenues) and (b) "[i]s the primary source of employment of the principal investigator of the proposed R&D." In the 1983 revision of the policy directive, the SBA again did not select a 51-percent "individual" ownership or control standard for its SBIR size standard. Rather, it referred to "citizens," which in statutory and legal parlance is commonly understood to apply to corporations, as well as other entities.

The first time the SBA introduced the concept of individual ownership for the SBIR program was in its December 1989 promulgation of a formal regulation in (then) 13 CFR § 121.1202. The regulation stated:

> [A] business concern must be at least 51% owned and controlled by an individual(s) who is (are) citizens of or ... resident aliens in the [U.S.], and, including affiliates, may not have more than 500 employees.

Although the SBA promulgated that regulation in 1989, the policy directive remained substantially unchanged until 2002, when it was revised to adopt an eligibility standard consistent with the regulation.

The change in the policy directive and the entire issue of "individual" ownership began with a 2001 decision by the SBA's Office of Hearings and Appeals (OHA). In *Size Appeal of CBR Lab., Inc.*, No. 4423 (Jan. 10, 2001), OHA affirmed an adverse size determination of a SBIR applicant on the basis that the term "individual" should be interpreted to mean only "natural persons." OHA, therefore, concluded that CBR Labs, which was a wholly owned subsidiary of a not-for-profit corporation, was ineligible to participate in the SBIR program. OHA expanded its *CBR Labs* ruling in a 2003 decision, in which it concluded that small businesses owned primarily by majority-owned venture capital firms and pension plans also were ineligible to participate in the SBIR program. See *Size Appeal of Cognetix, Inc.*, No. 4560 (May 29, 2003).

The Exclusion of Majority Venture Capital-Backed Companies—Through the *CBR Labs* and *Cognetix* decisions, the SBA has effectively excluded from the SBIR program many of the very companies that the program was intended to assist and those that are most likely to be viewed as attractive M&A candidates.

Most nascent technology companies, particularly in the biotechnology sector, depend heavily on outside investment to fund early-stage R&D efforts. These companies often attempt to commercialize one or more promising concepts, but have no established product "pipeline" on which to rely for ongoing financial support. Supporting these small innovative companies was, of course, exactly the reason why Congress established the SBIR program.

Indeed, Congress expressly stated that a primary purpose of the SBIR program was to "attract private capital to commercialize the results of the Federal research." S. Rep. No. 97-194, 97th Cong., 1st Sess. 1981, reprinted in 1982 USCCAN 512. Likewise, the SBIDA's legislative history devotes significant attention to the importance of "financial leverage" for small businesses:

> [T]ax incentives alone are insufficient support for small innovative firms. Some other incentive in the nature of ... 'proof-of-concept money' is necessary. Such money would support the exploration of innovative ideas in the early stages. Yet because technological risks are high in these stages, it is difficult for small research firms to attract this necessary start-up capital.

Id. at 6.

Congress, therefore, viewed SBIR funding as complementary to the private-sector funding necessary to commercialize promising technologies, never indicating that entities that are majority-backed by venture funds should be excluded.

In fact, Congress envisioned the SBIR program as providing the necessary "proof of concept" that private-equity investors view as significant when investing in high-risk R&D. For example, receiving multiple, highly competitive SBIR awards from NIH is evidence to the private-equity community that a company's concept has significant promise. Indeed, in testimony given before the establishment of the SBIR program, venture capitalists explained that they were reluctant to invest in new companies without a "track record," but viewed "the SBIR program as a type of 'preventure' investment which would complement the efforts of the venture capitalists." Id.

Thus, the Senate committee concluded that the SBIR program would provide small companies with "seed money" to encourage additional private investment and "facilitate the ability of participating firms

to attract venture capital." Id. at 7. Notwithstanding the clear congressional intent, companies with majority venture capital and or pension-fund backing are no longer eligible to receive new SBIR grants because of the SBA's recent interpretations. Likewise, when venture-backed firms acquire companies that have received SBIR grants, the acquired companies risk losing a future revenue source. Because size status is determined at the time of award (see NIH Funding Opportunity Announcement PA-06-120), existing SBIR grants may continue to be funded, but new awards may be in jeopardy. See, e.g., *Vantex Serv. Corp.*, Comp. Gen. Dec. B-251102, 93-1 CPD ¶ 221 (allowing a small business to continue performing after its acquisition by a large business).

Conclusion and Recommendations—In many cases, small technology companies have millions of SBIR dollars in their overall R&D budget, which makes them attractive acquisition targets. However, given the current interpretations of SBIR eligibility standards, both buyers and sellers must understand those rules before finalizing a merger or acquisition.

From a buyer's perspective, if an acquisition is likely to cause the acquired company to lose its ability to obtain future SBIR funding, the purchase price should account for that potential revenue loss. For example, assume the seller is currently performing five Phase I SBIR grants for NIH. Upon acquisition by a large company, the new entity will not qualify for follow-on Phase II funding for those research projects. This potential loss of revenue should be factored into the overall value of the transaction.

From the seller's perspective, it is equally important to consider whether, for example, the benefits of acquisition by a majority venture capital- or pension fund-backed company outweigh the possible loss of SBIR funding.

Finally, both parties need to assess whether the transaction structure creates any affiliation issues that could impact SBIR eligibility.

Understanding and analyzing SBIR eligibility rules will allow both buyers and sellers to properly evaluate a transaction and, perhaps, structure the deal ina way that avoids the loss of SBIR funding. For example, a large business or venture-backed firm may be able to structure a significant initial investment in a small company without jeopardizing its size status. Then, as the SBIR work is completed and a small business' technology nears commercialization, the firm may expand its ownership interest. Failure to consider SBIR ownership issues has the potential to result in an overvalued transaction, and could lead to the practical difficulty of replacing lost SBIR revenue. By considering these issues ahead of time, buyers and sellers will be able to make more informed decisions from both a financial and scientific perspective.

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