

A Battle Over Venture Capital for Small Businesses

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By Elizabeth Olson

(Washington, DC) - Representative Jason Altmire, a Pennsylvania Democrat, says he was just trying to help the small technology companies blossoming in his district, just north of Pittsburgh.

So when two of his constituents argued that small businesses should be able to qualify for federal research grants without being penalized for accepting venture capital money, he agreed to introduce legislation that would help them.

His bill, the Small Business Expansion Act of 2007, sailed through the Small Business Committee and then the full House of Representatives on a 325-to-73 vote last month. But the House adopted an important change as the measure came up for a vote - it specified that a small business could not give up an ownership stake of "50 percent or more" to a venture capital firm.

The amendment was meant to satisfy critics, among them officials of the Small Business Administration who argued that allowing venture capitalists to pour unlimited amounts of money into these fledgling businesses would fundamentally alter the concept of a small - and independent - business.

But as the legislation awaits Senate action, opponents argue that the amendment did not resolve their concerns. The S.B.A., they say, has long had discretion in determining whether venture capital's support of a small business represents an investment or whether it crosses the line into control of the company. The legislation, they say, takes away that discretion by spelling out a particular percentage.

In addition, the critics say they fear that the bill will clear the way for venture capital firms to use their investment to take a controlling stake, giving them the potential to masquerade as small firms and tap into billions of dollars in federal research grants and contracts.

That is an important and sensitive argument at a time when the government has been criticized for awarding contracts to large corporations operating under the guise of small businesses. Edsel M. Brown Jr., assistant director for S.B.A.'s office of technology, said the legislation was unnecessary because "a venture capital company already can invest more than 49 percent as long as it doesn't have ownership and control."

The White House also opposes the measure. "The provision would allow large businesses, not-for-profit organizations, and colleges and universities," a White House statement said, "to own and control small businesses and benefit from

programs designed for independent small businesses."

Quite the contrary, Representative Altmire insists, saying that his bill "does not favor any small business over another, but it also does not automatically disqualify a small business either."

He argues that the legislation is needed because many tech start-ups are "told by the Small Business Administration that they are ineligible for government money because they got venture capital money - and that doesn't make any sense."

Companies doing research in biomedical and military fields say they should receive government research funds on the basis of the quality of their work, not on how they are financed.

Biotechnology companies, for example, typically take years to generate revenues, which means they often have difficulty getting bank loans. So they turn to venture capital to survive, Scott Koenig, president and chief executive of MacroGenics, told the House Small Business Committee at a hearing in September on the measure.

The bill "would modernize the S.B.A.'s rules defining a small business so that small biotechnology firms are not prevented from accessing assistance and grants simply because venture capital is part of the business model," Mr. Koenig said.

But Giovanni Coratolo, the small-business director at the United States Chamber of Commerce, said the bill created "a loophole that would allow large businesses, colleges and universities to own an unlimited number of small businesses, but still fall under the definition of small business to access government resources and programs."

Once a business passes S.B.A. muster as a small business, it can qualify for certain federal programs. For example, biotechnology firms are eligible for grants from the National Institutes of Health, which parcels out more than \$22 billion annually to small and big businesses. Other government agencies also award research money, with the largest being the Defense Department, which has about \$1 billion a year for small-business research.

Gerard J. McGarrity said his former firm, Intronn, in Gaithersburg, Md., now owned by the Virxsys Corporation, ended up shutting down promising cystic fibrosis research in 2003 when the federal government cut off funds because Intronn had accepted venture capital investment.

"The private money was needed to keep going," he said, "but the cutoff of federal funds wiped out our research team."

The biotechnology industry said N.I.H. statistics showed how the current classification system was squeezing research.

Since 2004, there has been a 25 percent decline in the number of applications for its research funds, according to Congressional testimony by N.I.H. last June. And last year, only 26 percent of the applicants were new, the lowest percentage ever recorded for new research applications.

But the National Small Business Association, which opposes the legislation, maintained that small businesses financed with venture capital were faring well under government medical grants. An April 2006 report from the Government Accountability Office found that the percentage of N.I.H. research dollars awarded to these companies had risen to 21 percent in 2004 from 14 percent in 2001, the association said.

The American Small Business League and other foes have also questioned how the legislation would affect eligibility for government contracts. By law, about 23 percent of government contracts are supposed to go to small businesses.

"Our concern is that changing the definition of a small business would offset the progress the agency has made," said Charles E. Rowe, the S.B.A.'s assistant administrator for Congressional affairs.