Raising Funds as a Start-Up Cyber Security Company

Privacy, Technology and Data Security September 29, 2020

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Over the last decade, cyber security has become a predominant issue for many medium to large companies, as well as local and federal government agencies. Most companies and governments rely on the use of digital networks, devices, programs, and data in their everyday operations. As companies and governments increasingly rely on these tools, many cyber criminals have found ways to enter into private networks and systems to monetize or gain knowledge from such security breaches.

With every problem comes an entrepreneur with a solution. Cyber security entrepreneurs are developing security solutions for every access point vulnerable to a cyber criminal attack. Whether such unauthorized access or points of attack are vulnerable through networks, applications, digital infrastructures, cloud systems, mobile devices, or backup systems, sophisticated solutions exists in part due to startups active in this market segment. Most startup companies depend on raising outside capital to fund their product research and development.

According to Atlas VPN, an online privacy and security company, 78 new cyber security startups founded in 2020 have raised $31.6 million in funding year to date. These funds were privately raised through either convertible debt notes or priced equity rounds issued by each startup company to either a Venture Capital firm or an accredited investor. As the cyber security market segment continues to grow and new security issues arise, new startup entrepreneurs will emerge and will need to understand the general differences between raising operating capital through convertible debt notes and priced equity rounds.

Convertible Debt Notes

- A convertible note is a loan from an accredited investor. The principal and sometimes the interest of the loan are repaid at maturity (usually, 2-3 years) or, at the option of the noteholder or a predetermined event, such outstanding amounts due and owing are converted at maturity into equity ownership in the company.
- Key features of a convertible note are (i) the discount feature (rewards the noteholder for its risk by allowing such noteholder to obtain a cheaper price for the equity then offered to investors in the company's priced round), (ii) the cap feature (rewards the noteholder for its risk by allowing such noteholder to obtain a cheaper price for the equity, in a different way, then offered to investors in the company's priced round), and, (iii) avoiding the liquidation overhang (allowing for noteholders that negotiated a cap and discount to unfairly participate in the priced round's liquidation preference).
- A company should understand that the number of shares a noteholder will receive will depend on the next priced round's investors' valuation of the company.

Priced Equity Round

- A priced equity round is an equity based investment round in which there is a defined valuation of the company. Most companies offer a priced equity round when they seek to raise at least $500,000.00 or more.
- There are many key features that may be negotiated in a priced round, including but, not limited to (i) liquidation preference, (ii) protective provisions, (iii) board seats, (iv) preemptive rights, (v) drag and tag rights, (vi) registration rights, (viii) anti-dilution provisions, and (ix) voting rights.
- A company should understand that putting together a priced equity round is a long process and involves complex negotiations of many rights and controls an investor may obtain in connection with any such investment.

If you are a cyber security startup and would like additional information related to raising capital for your emerging business, please contact Edward Grattan for assistance.