What Are Pro Rata Rights?

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Pro rata rights can be a powerful tool to help startup founders secure a first round of equity or debt funding. To get its business started, a startup often sells Series Seed Preferred Stock to investors in an initial round of financing. As the startup grows and needs more money, however, it will need to issue and sell more shares of stock to interested investors in subsequent equity rounds. Resulting dilution can pose a problem for initial investors who wish to retain a certain ownership percentage in order to retain and protect certain rights (such as rights of a “Major Holder” or the right to designate a Board seat or Board observer).

To prevent the ownership percentage of early investors from being diluted, the company can offer pro rata rights to its early investors and thereby give them the right, but not the obligation, to participate in subsequent rounds of equity financing to maintain their initial ownership percentage in the company. In this way, the grant of pro rata rights both (i) rewards early investors for having taken the risk of making an early investment, and (ii) incentivizes them to invest again by guarantying them the ability to maintain their existing ownership percentage in the company. Pro rata rights can also be and often are granted to investors in later rounds of funding as an incentive -- particularly to large investors that provide significant financing to enable the startup to reach its “next level” of development and operations. The grant of such rights may benefit both the startup -- allowing it to better plan who might participate in future financing rounds, as well as Founders who may seek liquidity by offering to sell part of their equity to the early investors the Founders believe will continue to play an active role in the startup’s growth and development.

While it’s important to know the benefits of pro rata rights, it is equally important to be aware of the dangers they can present. If a startup expects to conduct several rounds of financing, it needs to carefully choose which investors will receive these rights, since it can be detrimental to allocate too large a percentage to existing investors when trying to engage new sources of investment. Moreover, pro rata rights do not guarantee an investment by existing stockholders. Investors may not exercise their pro rata rights if the Company’s future projections are marginal or uncertain. Founders must be aware that even if they successfully negotiate a round of funding with an investor, obtaining the investor’s participation in future equity rounds is not guaranteed.