

Follow-On Investment in a Venture Capital Financing – Pros and Cons to Consider

Companies that close a venture capital financing usually have multiple investors. Customarily, there will be a venture capital firm or other institutional investor that *leads* the investment round by investing the most money (referred to as the Lead Investor) and other investors that *follow on* with smaller investment amounts (referred to as the Follow-On Investors). The Follow-On Investors could be smaller venture capital firms, angel investors, wealthy family or friends, or other entrepreneurs.

Follow-On Investors typically receive the same class of equity as the Lead Investor. However, there are usually some material differences with respect to the relative rights of Lead Investors and Follow-On Investors. Below is a summary of the “pros” and “cons” of investing as a Follow-On Investor.

On the “pro” side, Follow-On Investors are usually able to efficiently deploy their capital. Because the investment documents are generally finalized and executed by the Lead Investor before the Follow-On Investor makes its investment, counsel for a Follow-On Investor will typically take a more “high-level” approach and will focus on any red flags in the deal terms and diligence. In effect, the Follow-On Investor will leverage the Lead Investor’s negotiating of terms, due diligence, and drafting of legal document. All of this helps to reduce legal fees. Follow-On Investors may also achieve a level of comfort knowing that they and the Lead Investor are betting on the same company. Finally, Follow-On Investors have the opportunity to develop relationships with the Lead Investor, which can put the Follow-On Investor on a short list to be invited to participate as a Follow-On Investor in future deals.

On the “con” side, Follow-On Investors are unlikely to get board seats or observer rights. This is because they are generally not putting in enough money to earn those governance benefits. As mentioned above, because Follow-On Investors typically enter the deal after the documents and deal terms have been fully negotiated by the Lead Investor, they will have a limited ability to negotiate. Additionally, and perhaps most importantly, Follow-On Investors may not meet the “major investor” ownership thresholds. Typically, in a venture financing, investors that bring a certain amount of money to the table are coined “major investors.” The major investors usually get additional information rights, inspection rights and pro-rata participation rights. Non-major investors may not get those rights, especially in cases where there are many Follow-On Investors. That being said, in certain circumstances, if a company is struggling to fill out a financing round, a Follow-On Investor may be able to negotiate to receive major investor rights (even though they don’t meet the ownership threshold). This will sometimes be documented in a stand-alone side letter (sometimes referred to as a ‘letter agreement’).

As you can see, there are pros and cons to follow-on investing in the venture capital context. While Follow-On Investors usually invest less money than the Lead Investor and save money on legal fees, a Follow-On Investor is unlikely to get all of the contractual rights enjoyed by the Lead Investor. As such, before you invest, it is important to carefully review any investment documents and understand exactly what rights you may or may not have in connection with your investment.

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Date Created

August 28, 2018