The next term in our series of other terms in the term sheet is right of first refusal. This is akin to what my wife Amy has with the TV remote when we're both watching TV at the same time.

Clint: What is a right of first refusal?

Brad: Right of first refusal is also commonly referred to as a pro-rata right. It's the right of an investor, who's already an investor in your company, to have a right to invest in the next round of financing at some percentage of that round.

Pro-rata rights define very specifically their ability to invest an amount that allows them to maintain the same ownership they have in the company by investing more money in your next round, alongside whatever new investors you might have.

Clint: That seems like a pretty reasonable term for an entrepreneur to sign up to. Are there ways that entrepreneurs can get in trouble with this?

Brad: Yes, generally you want the investor to have a right of first refusal or pro-rata right. You want to encourage your investors to invest in the next financing.

However, it's important that they have a pro-rata right only on the amount of their pro-rata. Some investors will ask for right of first refusal on a larger amount, especially as a seed investor.

If an investor who invested and owns 5% of your company as part of that investment asks for a right of first refusal on 20% of the company, that's not nearly as good for you, as the entrepreneur.

You could get in a situation where it scares away other potential investors because they look at it and say, "That investor is going to take that 20%." It limits your option.

When you give a right of first refusal, make sure it's a pro-rata right that doesn't have a multiple on it or isn't linked to a specific percentage of the company, but is just the simple pro-rata of whatever the investor has currently owned in your company.