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STARTUP LOTTERY

**Your Guide to Navigating
Risk and Reward**

by

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Glossary of Key Terms⁶⁰

83(b) election - A filing made by an employee with the Internal Revenue Service at the time restricted stock is issued either directly by the company or as a result of the early exercise of a stock option. The filing, which must be made within 30 days of receipt of the restricted stock, is designed to ensure that the stock receives capital gains treatment at the time of sale.

409A valuation - Refers to Section 409A of the Internal Revenue Code, which governs how incentive stock grants are issued. The value of a company's stock (usually common stock) at a given time that forms the basis for the company to set the exercise price for stock options. Must be conducted by an independent third party at least every 12 months or when a material event happens to the company that would affect the value of the company's common stock.

acceleration - The process by which stock options, restricted stock, and restricted stock units (RSUs) become vested more quickly than the underlying vesting schedule. The process is associated with specific events such as a company sale or change of control. See also trigger.

⁶⁰ Special thanks to Randy Domolky of PAN Investments for sharing some of his firm's definitions which are incorporated into this glossary.

active angel - An individual investor who takes an active role in helping an early-stage company by providing strategic or technical advice, coaching the management team, and making introductions to prospective customers and other investors. Also see angel.

advisory board - A group of experienced businesspeople who support the company with strategic advice, provide credibility, especially to pre-seed, seed, and early-stage companies, but have no governance power over the company's affairs. Also called board of advisors.

angel - An individual providing a relatively small amount of capital—typically less than \$250,000—to a startup for an equity stake in the company. Angels are most active in companies that are early stage and pre-revenue. Also see active angel.

annual recurring revenue (ARR) - The point-in-time snapshot of the annualized revenue associated with all currently active customer contracts. Often associated with SaaS companies.

anti-dilution provision - a feature of preferred shares that calls for the issuance of additional preferred shares to the holders if the company sells shares in a later funding round at a price per share lower than the price at which the preferred shares in question were purchased. Can result in significant dilution for common shareholders. See down round and recapitalization.

at-will employment - The right by an employer to terminate an employee at any time for any reason. A standard feature of most employment arrangements.

bargain element - The spread between the value of a share of common stock (for example, at the time of a company sale) and the exercise price at which an option holder may purchase the common stock. Represents the nominal value of the stock option at a given time.

basis - The price of a share of stock used to determine capital gains or losses when the stock is sold or written off.

board of advisors - See advisory board.

board approval - The process whereby the board of directors approves corporate actions, such as the issuance of incentive equity grants, by an affirmative vote of its members.

board of directors (BOD) - A group of influential individuals, elected by stockholders, chosen to oversee the affairs of a company. A board typically includes investors, mentors, and industry experts as well as members of the management team such as the CEO. Not all startups have a board, but larger institutional investors (i.e., venture capital firms) typically require a board seat in exchange for investment in a company.

bridge - A round of financing meant to provide enough capital to a company to allow it to operate until it can raise a full round or consummate a sale. Often funded by company insiders through convertible debt or a SAFE. Also called bridge round. Also see convertible debt and SAFE.

burn rate - The amount of net cash a company spends monthly to fund its operations.

capitalization - The collective funding a company has received over its life since inception. Usually refers to equity funding but can also include debt.

capitalization table - A spreadsheet listing the ownership of company stock by owner and class of stock. Includes shares outstanding overall and by class as well as the available shares in the option pool. Also called cap table.

carried interest - The mechanism through which venture capital firms profit from exits by their portfolio companies. A percentage

(usually 20 percent) of profits venture capital firms retain as compensation for managing investments in their funds using capital from outside limited partners, with the remaining percentage (80 percent) being distributed to the limited partners.

cashless exercise - A process for exercising stock whereby a portion of the exercised stock is forfeited to pay the exercise price in lieu of the option holder paying cash to acquire the stock. Most typically happens in public companies. Also see non-recourse financing.

change of control - The sale of more than 50 percent of the stock of a company, giving the buyer governance control over the company. An event that may trigger accelerated vesting of options.

churn - the loss of customers. A metric tracked to gauge how well a company is retaining customers and meeting market needs.

cliff vesting - A feature of the vesting schedule for incentive equity grants whereby a portion of the grant vests all at once after an extended period, typically a year, rather than on a monthly or quarterly basis. See also options and vesting.

common stock - the lowest class of stock representing ownership in a corporation. Usually, the class of stock held by founders and employees and the equity type underlying incentive grants such as stock options and RSUs.

conversion price - The price at which convertible debt or a SAFE converts into company shares (usually preferred shares). The conversion price is set by the terms of the convertible security, which typically provides a discount to the share price set in a financing round following the issuance of the convertible debt or SAFE. See also convertible debt and simplified agreement for future equity.

convertible debt - A loan made by an investor to a company with the right at the investor's option to convert the face value of the loan (plus accrued interest) into shares in the company. Usually issued in the early stages of a startup in advance of an equity funding round and converted into equity at a discounted price per share when the equity funding round is completed. Also called a convertible note.

customer acquisition costs (CAC) - A metric used to calculate the cost-efficiency with which a company acquires additional customers and revenue. Often evaluated by VCs relative to the expected lifetime value of a customer to determine whether the economics of a business are viable or progressing toward viability.

dilution - The reduction in a shareholder's percentage ownership in a company caused by the sale of additional stock or the issuance of stock options to other parties. See also fully diluted.

double trigger - The accelerated vesting of an equity grant contingent on two events happening. Most commonly associated with the combination of a change of control of a company followed by termination of the option holder within a specific period (i.e., 12 months). See also single trigger and trigger.

down round - A funding round through which investors buy shares at a valuation lower than the previous funding round. Generally considered a negative occurrence for the company as it can trigger anti-dilution provisions in preferred stock, leading to significant dilution for existing shareholders, especially common shareholders, along with a negative impact on the value of employee stock options. See also recapitalization, round, and up round.

due diligence - The process of validating the worthiness of a company for investment, purchase, or merger. Includes broad investigation and analysis of all aspects of the company, including legal status and compliance, financial results, operational stability,

technology, and personnel. Conducted using company-provided information and internal and external interviews and research. Typically takes place prior to the closing of a transaction. Also, a general term for using proper effort and research to evaluate an opportunity.

early exercise - The process of exercising a stock option prior to the option being vested. A provision offered in select cases, usually to executives, to optimize tax treatment of stock ownership from incentive equity grants.

early stage - A general term used to categorize a startup in the early phases of its lifecycle. Typically, will include companies that have yet to achieve substantial revenue or profitability. Term also used by VCs to identify the maturity of companies in which they invest.

equity - General term referring to all classes of stock or ownership interests in a company.

exercise - The purchase by an option holder of stock associated with a vested stock option. Involves the purchaser (option holder) paying the exercise price in cash to the company and receiving the stock in exchange. The process may trigger taxable income to the purchaser.

exercise price - The price at which the holder of a stock option may purchase a share of stock under an option agreement. The price is set based on the company's 409A valuation and ratified by the board of directors for inclusion in stock option grants. Also called strike price.

exit - The sale or initial public offering of a company. The method by which an investor and/or entrepreneur monetize their holding in a company.

exploding offer - A job offer with a short window (from a day up to a week) for the offeree to accept it, after which the offer is rescinded. Used by companies as a pressure tactic to get prospective employees to commit quickly.

follower - In a syndicate of investors, an entity that commits capital to a funding round while relying on the lead investor to negotiate terms with the company and conduct due diligence.

fully diluted - A calculation of stockholder ownership percentages that includes unissued shares held in the option pool in the denominator of the calculation. Fully diluted percent ownership equals shares held divided by (shares issued and outstanding plus the option pool). See also dilution.

general partner - a member of a venture capital or private equity firm responsible for sourcing, investing in companies and overseeing the firm's portfolio of investments. Often a member of the firm's investment committee and a board member for individual portfolio companies. See limited partner.

generally accepted accounting principles (GAAP) - A set of standards and guidelines established by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) governing how company financial transactions are accounted for and recorded.

growth stage - the stage of a startup's development after early stage. Characterized by rapidly growing revenue, often exceeding 100 percent per year. Includes companies with annual revenues exceeding \$3 to 5 million.

incentive equity - A form of direct or derivative stock ownership in a company, usually issued to employees, contractors, advisors, and board members. Includes stock options, restricted stock, restricted stock units, and warrants.

incentive stock options (ISO) - A form of stock option issued only to employees that provides tax advantages (such as capital gains treatment) if exercised and held for more than a year. Issuance amounts are subject to limitations of no more than \$100,000 of such options vesting annually.

incentive stock plan - The document issued by the company and approved by the board of directors governing the issuance of incentive stock grants such as options and restricted stock. The document sets terms such as standard vesting schedules, procedures for grant issuance, ISO and non-qual issuance, and forfeiture and repurchase procedures.

insider round - A funding round in which all the capital is provided by previous investors in the company without participation from new investors.

intellectual property - Intangible assets of a company such as patents, trademarks, copyrights, and trade secrets.

issued and outstanding - A term used when calculating ownership percentages of stockholders. Excludes any unissued shares held in the option pool from the denominator of the calculation. Percent ownership equals shares held divided by shares issued and outstanding.

land and expand - A strategy used by companies to grow revenue. The approach entails closing small deals with customers and then working to increase the dollar value of the customer relationship over time by selling more products or services or selling into different departments or divisions within the same customer.

late stage - the stage of a startup's development after growth stage. Characterized by operations with significant revenue exceeding \$10 million with companies at this stage able to attract investment interest from private equity firms.

lead investor - In a funding round for a company, the investor who takes responsibility for negotiating the terms of the round, leading due diligence, and working with investor counsel on behalf of the syndicate of investors in the round. Often but not always the largest investor in the round, also known as “leading the round.” When the investor is a venture capital firm, also called the lead VC.

lead VC - See lead investor.

lifestyle business - A company, usually a small business, that provides income and lifestyle flexibility to the owner(s). Typically, not a business that outside investors fund as the goal of such a business is not to maximize growth and returns to investors.

limited partner (LP) - an investor who commits capital to a venture capital or private equity fund. May be a high net worth individual or an institutional investor such as an insurance company, pension fund, or other asset manager. Usually, a passive investor who relies on the venture capital or private equity firm to select companies to invest in and manage the portfolio of investments on the LP’s behalf.

liquidation preference - The right to receive priority distribution of proceeds from a sale or liquidation of a company. Usually associated with preferred stock.

liquidity event - A financial transaction, such as a merger or acquisition, that provides shareholders of a company with a payout of cash or other forms of compensation for the sale of their stock.

lock-up period - The time, usually 180 days but can vary, after an initial public offering of company stock during which insiders in the company (executives, employees, board members, private investors, and advisors such as lawyers, etc.) may not sell their stock. This practice is designed to provide stability to the stock price

and keep large inside shareholders from dumping their stock and running after the IPO.

management carve-out - An agreement by the board of directors to reward specific employees for results, such as the successful sale of a company. Generally paid prior to investors receiving the proceeds from the sale. Often used if the sale will result in minimal or no payment to common shareholders and option holders to keep management focused on completing the transaction.

net revenue retention rate - A metric used by companies to track customer loyalty and churn. Takes into account loss of customers as well as expansion of customer revenue through increased sales. Also called net dollar retention rate. See land and expand.

nondisclosure agreement (NDA) - A legal agreement between two entities, whether individuals or corporations, that restricts how confidential information provided by the parties to each other may be used and shared with third parties.

non-participating preferred - A form of preferred stock that offers shareholders the right to receive their liquidity preference payout (usually 1 time their investment) or convert into common shares and participate *pro rata* in the proceeds to common shareholders. This form of preferred stock is less investor friendly and more company friendly than participating preferred. Also see participating preferred.

non-qualified stock options - A form of non-cash compensation that provides employees, advisors, contractors, and board members the right to purchase the stock of a company at a specified exercise price. Usually subject to a vesting schedule. “Non-qualified” refers to the tax treatment of the option, which receives no special tax treatment, unlike incentive stock options. Also called non-quals, NSOs, or NQSOs. See incentive stock options.

non-recourse financing - A loan provided by a third-party source to enable the exercise of stock options by an option holder without using their own cash. The third party accepts the purchased stock as full collateral for the loan, and repayment takes place at the time the stock is sold. The third party takes a portion of the upside when the stock is sold as compensation for providing the financing.

on-target earnings (OTE) - The total dollar amount, including salary plus incentive cash compensation such as bonuses or commissions, an employee should expect to earn if they meet their goals (including company goals if a portion of the bonus is driven by company performance).

option — The right granted by a company to employees, contractors, advisors, and board members to purchase shares of the company's stock (usually common stock) at a set exercise or strike price. Typically contains a time-based vesting schedule requiring a period of service by the grantee to the company before that right becomes active. Also called stock option.

option pool - The common shares allocated on a company's capitalization table and held in reserve for the issuance of incentive stock grants such as options. Represents unissued shares that do not receive proceeds in the event of a company merger or sale. See also issued and outstanding and fully diluted.

partial acceleration - The process by which a portion of the unvested stock options, restricted stock, or restricted stock unit (RSU) grants become vested more quickly than the underlying vesting schedule. The process is associated with specific events such as a company sale or change of control. See also acceleration and trigger.

participating preferred - An investor-friendly form of preferred stock that offers preferred shareholders a preferential payout of proceeds from a liquidity event *plus* the subsequent right to convert

into common shares and participate pro rata in the proceeds to common shareholders. The participation feature typically calls for a priority payout of 1 time the invested capital but can also be a higher multiple of the investment depending on what is negotiated in the funding round. See non-participating preferred.

penny warrant - The right granted by a company, usually to banks or other vendors, to purchase shares of the company's stock (usually common stock) at a negligible exercise or strike price (sometimes \$0). Used as a sweetener to induce the recipient to do business with the company.

post-money valuation - The valuation of the company immediately following the injection of new capital in a funding round, consisting of adding the capital invested to the pre-money valuation and accounting for the issuance of new shares to the investors. See also pre-money valuation and valuation.

preference stack - The total amount of consideration that must be paid to preferred shareholders before payment can be made to common shareholders and incentive equity grant holders (i.e., employees). Usually equals or exceeds the amount of capital raised in all prior rounds. See also liquidity and waterfall.

preferred shares - See preferred stock.

preferred stock - A class of stock with liquidation preferences regarding the distribution of proceeds from a liquidity event. Often comes with corporate governance rights such as special voting and representation on the board of directors. Also called preferred shares.

pre-money valuation - The valuation of a company as determined by negotiation between the lead investor and the company prior to the injection of new capital. A key term in a term sheet offered by a prospective investor. See also post-money valuation and valuation.

pre-seed stage - The earliest stage of a startup, often before a company has raised outside capital. Sometimes used interchangeably with seed stage to emphasize how young the company is.

private equity - a broad category of investors focused on taking majority or full ownership stakes in mature private companies that have achieved substantial revenue and profitability. Generally focused on later-stage private companies than early-stage companies funded by venture capital firms. An important source of exits for startups.

product management - The function within a company that coordinates the activities of product development/engineering with the sales and marketing teams. Assesses market needs for a product or service and translates market feedback into development plans for the offering while also helping shape sales and marketing strategies and messaging. .

proof continuum - A seven-stage construct that reflects the full lifecycle of a startup from inception to sale or initial public offering. Reflects the key milestones companies must achieve to continue to demonstrate momentum and attract investment capital.

pro rata - From the Latin ‘in proportion.’ Refers to the right of investors to receive cash proceeds from the company in accordance with their percent ownership. Also refers to the right to invest in future funding rounds in proportion to prior ownership or previous investment.

proprietary information and inventions agreement - An agreement required by employers specifying restrictions on employees’ use of and disclosure of a company’s intellectual property (IP), ownership of IP developed by employees while at the company, and other key provisions and restrictions, including but not limited to nondisclosure of confidential information, nonsolicitation of

company employees and customers after employees' departure, and non-competition provisions (as permitted under the law).

recapitalization - A funding round completed at a lower valuation than prior rounds, usually when a company is in a distressed position. Sometimes accompanied by a restructuring of the capitalization table and the activation of anti-dilution provisions for preferred shares. See also down round.

regreen - The practice of providing new incentive equity grants to employees whose prior grants are reaching high levels of vesting. A tactic used by employers to create employee retention incentives.

restricted stock - A type of stock grant, usually common stock, issued as incentive compensation. The grant vests over time, and the unvested portion is subject to forfeiture upon the recipient's departure from the company. Also, stock acquired through the early exercise of options that have not yet vested. This form of incentive compensation maintains certain favorable tax treatment relative to restricted stock units and is usually issued to senior staff in a company. See 83(b) election and early exercise.

restricted stock unit (RSU) - A form of stock grant, usually common stock, issued as incentive compensation. The grant vests over time, and the unvested portion is subject to forfeiture upon the recipient's departure from the company. Similar to restricted stock but lacks the favorable capital gains tax treatment associated with restricted stock. Subject to ordinary income taxes upon vesting.

reverse merger - The process whereby a shell public company with no business operations merges with an operating company for the purpose of creating an operational publicly traded company.

round - A financing event during which a company raises capital from a group of investors. Startups raise funds from venture capital

firms in individual rounds of funding, depending on the stage of the company. The sequence of rounds typically consists of a seed round followed by Series A, B, C, and D rounds, etc.

runway - The time frame usually expressed in the number of months until a company runs out of money, given its current cash reserves and burn rate. See burn rate.

simplified agreement for future equity (SAFE) — An agreement used by early-stage companies to accept investment in advance of a later funding round. Usually issued in the early stages of a startup in advance of an equity funding round and converted into preferred shares at a discounted price per share when the subsequent funding round is completed. Developed by Y Combinator as a more company-friendly alternative to the issuance of convertible debt.

seed - The first official round of financing for a startup. Typically used to fund hiring of early employees and development of a prototype. See also seed stage.

seed round - See seed.

seed stage - The stage of a pre-revenue company shortly after inception when its focus is on raising funds for proof of concept and building a prototype.

series preferred - A general term referring to stock from all funding rounds where preferred stock has been issued (e.g., Series A, Series B, etc.).

severance - Payment of continued compensation for a fixed period after the termination of an employee's employment by the company. May be paid out to any employee terminated but is often associated with a negotiated term in the employment agreement of executives.

single trigger - A feature of an incentive equity grant that provides acceleration of the unvested portion of the grant upon the occurrence of a singular event such as a change of control. See also change of control, double trigger, and trigger.

special purpose acquisition company (SPAC) - A blank-check company or shell corporation with no operations, listed on a stock exchange for the purpose of merging with a private operating company. The SPAC enables a private company to go public without going through the traditional initial public offering (IPO) process.

stage - A phase of development of a startup company. Startups are categorized as seed stage, early stage, growth stage, and late stage. Also a focus of a venture capital firm's investment strategy defining the level of maturity of companies it seeks to fund.

stock - Ownership interest in an entity as represented by shares or ownership percentages. Terms associated with this general term include common stock, convertible preferred stock, non-participating preferred stock, participating preferred stock, preferred stock or preferred shares, restricted stock, restricted stock unit (RSU), and series preferred. Also can be referred to as shares.

strategic buyer/investor - A non-financial company that purchases or invests in a startup to enhance the buyer/investor's product offerings or customer base. Usually an operating company.

strike price - See exercise price.

term sheet - An agreement between a company and prospective investor(s) that outlines the major aspects of an investment to be made in the company. Typically issued by a venture capital or other lead investor in a round. Sets the groundwork for creation of detailed legal documents necessary to close the round. It is typically non-binding and contingent on successful completion of due diligence.

termination - The act of a company discontinuing the employment of a staff member.

termination for cause - Termination based on the employee's violation of their employment agreement. May involve fraud, gross negligence, or commission of a crime, among other conditions. Also called termination with cause. See termination.

termination without cause - Termination of employment by the employer without specific justification such as the employee's violation of the employment agreement or company policies. The subject of a clause in the employment agreement that triggers severance obligations due from the company to the employee. In the case of double trigger acceleration, also the second trigger to cause acceleration of vesting of unvested equity incentive grants. See acceleration, severance, and trigger,

trigger - An event that causes the full or partial acceleration of vesting associated with an incentive equity grant such as a stock option. Most commonly associated with a change of control of the company.

underwater - The status of a stock option in which the exercise price of the option is below the value of the underlying common stock that would be purchased if the option were to be exercised. Also referred to as out of the money.

unicorn - A startup whose valuation exceeds \$1 billion based on its most recent funding round or valuation.

unvested - The status of options or restricted equity subject to a vesting schedule in which the holder does not currently have the economic or other rights associated with the holding. The unvested holding is subject to forfeiture upon the holder's departure from the company. See also option and restricted stock units.

up round - A funding round where the price per share paid by investors is higher than in the previous round or rounds, resulting in an increased valuation of the company being funded. See also down round and round.

valuation - The market capitalization of a company derived from multiplying the share price times the number of shares in the company. Also, the process by which a company's worth or value is determined or the actual stated monetary value. In a private company, it can be a subjective number determined by the company or outside investors or valuation firms that analyze capital structure, financial performance, management team, customer base, and market opportunities, among other factors, to determine the worth of the company. See also 409A valuation.

venture capital (VC) - The industry comprises firms investing in early, growth, and late-stage private companies. Also, the actual funding provided by the firms in the industry.

venture capitalist - A firm or individual engaged in the business of investing capital from third parties in high-growth potential private companies, usually in their early stages of development. See also venture capital and limited partners.

vest - The process by which an incentive equity grant holder obtains the economic rights associated with their grant. In the case of options, once the grants or a portion thereof is vested, the holder has the right to exercise the options. In the case of restricted stock units, once vested, the holder owns the shares outright.

vesting schedule - A time-based protocol whereby the exercise rights of incentive equity grants such as options and restricted stock units are activated. Usually, a three to four-year period. See options, exercise, restricted stock, vest, and unvested.

warrant A form of option to purchase a company's stock usually issued to another company as a sweetener for a commercial transaction, such as a bank loan or an important customer contract or to enhance the attractiveness of an investment in conjunction with a funding round.

waterfall - The order of priority by which proceeds from a liquidity event are distributed to creditors, shareholders, advisors (such as lawyers and investment bankers who help with the sale transaction), employees, and other interested parties.