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# STARTUP LOTTERY

**Your Guide to Navigating  
Risk and Reward**

by

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## The Startup Lottery Footnotes

1. Investopedia defines a SPAC as “a company without commercial operations and is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring or merging with an existing company.” This process whereby a shell public company merges with an operating company for the purpose of creating a publicly traded entity with business operations is known as a “reverse merger.” Julie Young, Samantha Silberstein, and Katrina Munichello, “Special Purpose Acquisition Company (SPAC) Explained: Examples and Risks”, Investopedia.com, <https://www.investopedia.com/terms/s/spac.asp>, March 15, 2023.
2. Wasserman, Noam “The Founders Dilemma.” hbr.org, *Harvard Business Review*, <https://hbr.org/2008/02/the-founders-dilemma>
3. NIL - Name, Image, and Likeness. Refers to the endorsement deals college athletes are permitted to receive after the NCAA lifted restrictions on such compensation in June 2021 as a result of legal action.
4. Potomac Dining LP, (d/b/a Transmedia), a franchisee of Transmedia Networks, was Number 410 on the 1998 *Inc. 500* list. The company is listed here as Transmedia: <https://www.inc.com/magazine/19981015/1105.html>
5. Jeffrey Bussgang of Harvard Business School and Flybridge Capital has written extensively on startup life. I recommend his article: Jeffrey Bussgang, “Are You Suited for a Startup?”, hbr.org, *Harvard Business Review*, <https://hbr.org/2017/11/are-you-suited-for-a-start-up>. (November-December, 2017).
6. Coincidentally, when Fugue set up its first Washington, DC office, it was in a WeWork and the square footage per employee was also 50. It was anything but free. The rent was about \$150 per square foot.
7. Company reporting to investors is based on quarterly and annual performance. It is critical to sign as many customer contracts by year-end as possible, so the winter holidays and even New Year’s Eve are a time when many deals are finalized.
8. *Opportunity cost* is the potential lost or missed benefit associated with other options that are not chosen. Choosing one job means foregoing the potential associated with other jobs you might have taken but decided not to.
9. With the rise of remote work during the pandemic that began in 2020, reports emerged of employees taking advantage of their employers by working two full-time jobs without either employer’s knowledge. Jack Kelly, “The Remote Trend of Working Two Jobs at the Same Time Without Both Companies Knowing,” *Forbes*, August 15, 2021, <https://bit.ly/3PHJ7dS>
10. The differences in compensation between startups and big tech varies depending on the startup funding environment. When startup funding is abundant, startups may be in a better position to close the gap. “Startups vs. Big Tech: What Entry-Level Employees Are Really Paid.”, startupsearch.com, <https://startupsearch.com/early-startup-big-tech-entry-compensation#heading-1> (accessed April 18, 2023)
11. If you’re joining as a senior executive, other elements of the offer may be just as important as salary, as the potential value of equity may be much higher than the cash compensation. An incoming CEO hired into a Series A or Series B startup will receive an equity grant of between five and eight percent of the ownership of the company. While the CEO’s salary may exceed \$250,000 per year, in the case of a successful exit, their equity payout may be in the millions or even tens of millions of dollars.
12. The company also took advantage of the federal Payroll Protection Program loan to supplement cash reserves and cover compensation.
13. A plan summary is a document issued by an insurance company or a retirement plan provider that details the specifics of the plan’s offerings. It is usually a dense document, but worth reviewing.
14. Companies that track vacation hours must accrue earned hours each pay period and track the balance against PTO used. That is a burden on the finance team. For small companies trying to do more with less, unnecessary tasks that can be eliminated should be. By not accruing vacation hours, when employees leave the company, there are also no accrued vacation days that have to be paid out in cash, which cash-constrained startups find attractive.
15. At-will employment is not unique to startups. It is also a standard term of employment for large companies.

16. Non-compete clauses across the US have been under scrutiny and may be watered down or eliminated. It is worth understanding how non-compete clauses are viewed or enforced where your prospective employer is located and where you plan to work.
17. If your offer happens to include a severance clause, ask for a copy of the Company's standard severance agreement, and try to pre-negotiate the language in the agreement at the time of the offer. If you wait until you are terminated, you will lose a lot of your leverage in negotiating the agreement. You really don't want to negotiate those terms when you are already at odds with the company.
18. U.S. Department of Labor, [dol.gov](https://www.dol.gov/general/topic/health-plans/cobra), <https://www.dol.gov/general/topic/health-plans/cobra> (accessed July 8, 2023).
19. Some of the items on the checklist will be explained in later chapters. Return to this checklist and review it after completing the book and use it each time you are entering into offer discussions.
20. The Articles of Incorporation and the Charter are two foundational documents that specify the core provisions around the issuance of C corporation stock, including economic rights and governance provisions. Additional documents issued during funding transactions include the Stock Purchase Agreement, Investor Rights Agreement, Voting Rights Agreement, and Disclosure Schedule.
21. Venture banks such as Silicon Valley Bank concentrated on their broad relationships with venture capital and private equity firms to fuel their growth during boom times in the innovation economy. Ironically, it was this over-concentration on the sector that led to the collapse and subsequent takeover of Silicon Valley Bank when the tech markets stagnated and venture funding for risky startups dried up.
22. The discount to the conversion price associated with convertible debt is an incentive for investors to commit to funding the company in advance of a future funding round.
23. Consult this article for a brief history of and explanation of revenue-based lending: "Revenue-Based Financing: A Powerful Lending Option", Saratoga Investment Corp., <https://saratogainvestmentcorp.com/articles/revenue-based-financing/>, June 30, 2020
24. A derivative is a security derived from its relationship with another security. For example, an option to purchase common shares is dependent on the underlying common shares for its existence. Without the common shares, there would be no option; the option has no value except in reference to the value of the common shares.
25. Typically, the dividend feature of preferred shares required dividends to be declared by the board. Additionally, undeclared dividends were non-cumulative from year to year, so if undeclared, presented no obligation for payout by the company. This is a relatively benign and common dividend construct, but not all venture deals are structured in such a company-friendly way.
26. Feld, Brad and Mendelson, Jason, *Venture Deals*. 2nd Edition. Hoboken, New Jersey, John Wiley & Sons, 2013.
27. The cap table is cleaner without participating preferred shares. Participating preferred complicates the flow of funds in a sale. New investors want a clean hierarchy of cash distributions represented in the waterfall without prior round investors having priority claims over the new investors' distributions, which participating preferred may have in certain situations.
28. A commonly used term for an investor who imposes onerous terms on distressed companies with the aim of extracting large gains when the company sells is a "vulture capitalist."
29. Further explanation and sample SAFE documents can be found at: <https://www.ycombinator.com/documents>.
30. The capitalization table only captures equity ownership and does not list debt obligations other than potentially convertible debt that can convert to equity.
31. An independent valuation of a company's common stock is required under Section 409A of the Internal Revenue Code to set the minimum price for option exercise prices. The purpose of the valuation is to ensure that company management and the board are offering incentive-based equity compensation at fair-market value. This is designed to protect shareholders from self-dealing on the part of company leadership.
32. As restricted stock is usually issued only to senior executives, I will not spend a lot of time on it here.
33. Dilution occurs when options from the pool are actually issued. The existence of a large option pool does not intrinsically cause dilution since unissued options or incentive stock shares would not affect the distribution of proceeds at the time of a liquidity event.
34. Real or even perceived failure on the part of company management and the board to fulfill their fiduciary responsibilities to investors can result in litigation pitting the investors against the company. This often happens at the time of a company exit when the distribution of proceeds becomes clear.

35. "On an as-converted basis" means that preferred shareholders receive the right to vote alongside common shareholders as part of the common share class based on the number of common shares their preferred shares would convert into, even if that conversion has not yet taken place.
36. I say "notional price" because valuing a startup is an inexact process, especially prior to any outside funding. The value of the shares was assigned without reference to any metrics or valuation methodology.
37. The shares were worth \$10,000 when originally issued and \$3,000 when sold, so I could claim a capital loss of \$7,000 on my taxes, recouping a portion of my loss.
38. As of 2023, the employee's portion of payroll taxes could be as high as 7.65% on wage-related income.
39. As of 2023, the savings in federal taxes from long-term capital gains treatment could be as high as 22%.
40. Exercising ISOs may subject you to the Alternative Minimum Tax (AMT). If the bargain element is significant (i.e., you have a large built-in gain) when you exercise, the deferral of the taxes on the gain is considered phantom gains and potentially subject to AMT. Before exercising ISOs, consider the impact that action will have on your tax liability. ESO Fund provides a good explanation and gain calculator for ISO exercises. <https://bit.ly/3XINRSL>
41. An example of a large grant of ISOs: An executive receives a grant of 1 million shares that vest over 4 years at an exercise price of \$1. Each year, 250,000 shares vest. Only 100,000 of those vested options would qualify as ISOs each year (100,000 options x \$1 per share). Each year, the remaining 150,000 options would become NSOs. Over the life of the grant, 400,000 options would be ISOs and the remaining 600,000 would become NSOs. There is still a substantial potential tax benefit if the executive takes advantage of the ISOs and exercises them, and the company is ultimately sold for a substantial price.
42. This is only true if the acquisition price is high enough to cause preferred shareholders to convert their shares to common shares and if their preferred shares are not participating preferred. In situations where the price is lower or there are participating preferred, the preferred shareholders will have preferential claims on cash flows that reduce the payout to common shareholders dollar-for-dollar.
43. "Derived by economists Myron Scholes, Robert Merton, and the late Fischer Black, the Black-Scholes Formula is a way to determine how much a call option is worth at any given time." *The Formula That Shook the World*, pbs.org, <https://www.pbs.org/wgbh/nova/stockmarket/formula.html> (accessed July 7, 2023)
44. It is possible, but not common, for existing option grants to be modified to add acceleration. As with any change to an option's terms, this change requires board approval, which management will be reluctant to ask for unless pressed.
45. In certain circumstances, option holders may be able to access third-party lenders to finance for options exercises. These financing sources typically only require pledging the underlying stock as collateral for the loan, so do not pose any additional risk on the borrower other than the loss of the stock if its value falls below the size of the loan.
46. Joshua Dietch and Taha Choukhmani, "Automatic enrollment's long-term effect on retirement savings," *T. Rowe Price Insights on Retirement*, <https://trowe.com/3JRhxHw>, June 2022.
47. The famous words of Jim McKay in the opening sequence to the television series *Wide World of Sports*. *Wide World of Sports*, 1961 through 1998, ABC.
48. The IRS has created a Qualified Small Business exclusion, commonly referred to as the Section 1202 Exclusion, that exempts certain shareholders who hold stock for more than 5 years in qualifying companies from paying federal capital gains taxes on the gains realized from a sale.
49. Options exercised right after issuance incur no ordinary income tax, because the company's 409A valuation per share of common stock remains the same as the exercise price per share and there is no built-in gain from stock appreciation.
50. Calculating the Alternative Minimum Tax is complicated. If you hold ISOs that you are considering exercising, consult with a tax professional before doing so as the resulting tax bill could be substantial with no incoming cash to cover it.
51. Net Promoter Score or NPS is a measure of customer satisfaction based on customer surveys that identify the likelihood of customers to promote a company or its products and services to others. "*The History of Net Promoter*", Bain & Co., <https://www.netpromotersystem.com/about/history-of-net-promoter/>
52. For a more comprehensive description of stock option financing, refer to Bruce Brumberg, "Financing Stock Option Exercises in Private Companies: Insights From a Top Financial Advisor," *Forbes*, September 20, 2021, <https://bit.ly/3pDAWEQ>
53. OKRs were developed in the early 1970s by Andy Grove at Intel Corporation as a way to keep management at the company on track in achieving its goals. For a more detailed explanation of OKRs, refer to: John Doerr, *Measure What Matters*, (New York: Portfolio/Penguin, 2018).

54. Venture capital firms attract investment from limited partners, who are outside institutional investors or high net worth individuals. Limited partners want to invest in VC funds run by firms with successful track records in their prior funds.
55. Companies that are not moving quickly toward an attractive exit but are also not likely to fail anytime soon are referred to as “living dead” or “zombies.” They continue to exist but are perceived by investors to be going nowhere.
56. Loizos, Connie, “Harry Weller, a ‘Midas List’ VC and the head of NEA’s East Coast practice, has passed away”, TechCrunch, <https://bit.ly/3JMOVIE>, November 20, 2016.
57. “Employee Tenure Summary”, U.S Bureau of Labor Statistics, <https://www.bls.gov/news.release/tenure.nr0.htm>, September 22, 2022.
58. Harvey Mackay, *Dig Your Well Before You’re Thirsty* (New York: Crown Business, 1997).
59. “Third Party Insourcing,” *Silicon Valley*, Season 1, Episode 6, directed by Mike Judge, written by John Altschuler, Dave Krinsky, and Mike Judge, HBO, 2014
60. Special thanks to Randy Domolky of PAN Investments for sharing some of his firm’s definitions which are incorporated into this glossary.