PAKISTAN STARTUP TOOLKIT

In partnership with Mubariz Siddiqui

At Invest2Innovate, we are dedicated to supporting startup communities in growth markets. Over the past seven years, we've worked closely with young entrepreneurs in Pakistan as well as with local investors, and have noted the overarching lack of information in this space, particularly as it relates to early-stage companies. In 2016, we released the i2i Investor Toolkit, a 101 guide to investors looking to operate in Pakistan, and to this date it is our most downloaded report. We realized it wasn't enough to just equip investors with the right information if we weren't also doing the same for startups. We have seen too many amazing companies die because founders made poor decisions that could have been avoided had they had the right information or access to good legal advice. Pakistan is a tricky environment to navigate and understand. We believe that knowledge is power, and no founder should be left in the dark and forced to make decisions because they just don't know better.

The i2i Pakistan Startup Guide was designed in partnership with independent legal practitioner Mubariz Siddiqui. Mubariz was a contributor to our 2016 Investor Toolkit. He is an independent legal practitioner and is also the co-founder of Wukla, which is leveraging design and technology to make regulatory compliance and law easy. There are links to download Wukla's free contract and legal agreements in this guide.

If you have any questions you felt were missing in this guide, would like to chat further about i2i's startup accelerator program, would like to get in touch with the lawyer mentioned above, or would like to let us know how we're doing, please drop i2i's CEO Kalsoom Lakhani a note at kalsoom@invest2innovate.com.

DISCLAIMER

The i2i Startup Toolkit highlights questions that our company has come across in the past seven years we have operated in Pakistan. However, no aspect of this document constitutes legal advice, or any other form of professional advice to be relied upon by any startup or otherwise as a determinative factor in making legal decisions. i2i disclaims any and all liability whatsoever with respect to the contents of this document and strongly encourages readers to consult professionals, including attorneys, well-versed in Pakistani law prior to making any major decisions. It is also important to note that laws and policies in Pakistan can change at any time, and be subject to different interpretations.

Why should I register my company?

We often meet entrepreneurs who have been running their startup for some time without officially registering (incorporating) their business. While this is understandable given the current taxation policies (which can be expensive for startups!), it is advised to register your company if and when you plan to raise funding or investment (equity or debt), if you plan to operate as a legal entity in the formal marketplace, or if your business is of the nature that could incur liability. Also, if your company needs to sign on partners/affiliates, or even needs to use payment providers like Jazz cash or Easy Paisa, you will need to be a registered legal entity.

Because registration can take 5-6 weeks or more (3 weeks to incorporate your business, 1 week to set up a bank account, and 1 week to get your tax registration, or your National Tax Number, NTN), it is advised to begin the process sooner rather than later.

How do I register my company?

Registering a company in Pakistan via the Securities and Exchange Commission Pakistan can be a relatively painless process, and the SECP website has a simple step by step guide on incorporating a company (specifically a private limited company), which you can access here. TechJuice has a really good step by step guide for company registration and NTN registration here. Here's the TL:DR version of the guide, according to Companies Ordinance 1984:

★ Step 1: Check the availability of your company name from the registrar.
★ Step 2: File the required documents: **(i) Form - 1** (Declaration of applicant for incorporation) (**ii) Form - 21** (Notice of situation of registered office of the company) **(iii) Form - 29** (Particulars of first directors of the company) **(iv) Memorandum and articles of association (4 copies) (v) Copy of national identity card or passport** (in case of foreigner), of each subscriber and witness to the memorandum and articles of association. **(vi) Registration / filing fee** (Original paid challan) **(vii) Authorization by sponsors /power of attorney**

You can also choose to file your application *online*, via this website: https://eservices.secp.gov.pk/eServices/. While you can choose to conduct this process on your own, it can be easier to hire a lawyer to file on your behalf in order to not cause any unnecessary delays or issues in your registration process. This should cost about PKR 20,000 - 30,000.

Once you've registered your company, you need to also apply for your National Tax Number, or your NTN, at the tax facilitation of the Regional Tax Office (**RTO**) of the Federal Board of Revenue (**FBR**). Your NTN is needed to open your business bank account and conduct business. Without your NTN, for example, your startup will not be able to do business with any large corporation (because you will not be able to withhold any tax from the larger business, which is a regulatory requirement.

What are the different kinds of legal entities for registering a business?

In registering your business in Pakistan, your options are:

★ **Partnerships**
★ **Sole Proprietorship**
★ **Single Member Company**
★ **Private Limited Company**
★ **Limited Liability Partnership**

★ **Section 42 Non-Profit**
★ **Trust**
★ **Societies**

Before we delve further into what these legal entities are, here are two important concepts to understand first: (1) a ***separate legal entity*** is when a new entity is created on paper. The entity is a separate person capable of owning property, entering into contracts, borrowing money, etc. (2) **limited liability** is when an entity is liable for its own losses and the owners of the entity are only exposed to the extent of the money they have invested. All liabilities beyond that rest on the entity, not on the owners.

A ***sole proprietorship*** involves an individual starting a business under a trade name. A ***partnership****,* meanwhile, is when more than one person starts a business, and their relationship is governed by a partnership deed.

Partnerships and sole proprietorships*,* therefore, while they may be relatively easier and quicker to register (and your tax liability is lower), are actually **not considered separate legal entities and do not limit liability**. Liability determines whether a business should shift from a partnership to a company. While a single member company is a new entity introduced into Pakistani law and allows you to register as a single member private limited company, it's not advised for startups raising investment (since an investor would come in and you would no longer be single member). You can convert from a single member to a standard private limited company, but it is a process to do so.

If your business is a high-risk business, you should register it as an incorporated company (i.e., a **private limited company)** , which *is* a separate entity and has limited liability. Also, if you plan to raise investment or capital (through equity or debt), you should do that as a **private limited company** because it limits the liability or reduces the risk for an investor.

If your business is planning *not* to generate profits and if you plan to accept grants as funding in the near future, you should register yourself as a **section 42 non-profit** (the steps to do this can be downloaded here via the SECP website). The process of attaining the section 42 license can take a long time (sometimes up to a year) and is more expensive, so it's important to get legal guidance if you plan on or are deciding to go down this route. Trusts and societies, in comparison, are easier to register than non-profits, but may not open you up to grant funding.

Bottom line: If you are a startup that is planning to raise investment or capital, and wish to limit liability, set up as a ***private limited company***.

I just read about a new type of entity called a Limited Liability Partnership. What is that?

In 2017, Pakistan's National Assembly passed the **Limited Liability Partnership Act**, which is significant as it introduces a new kind of entity that already exists in most parts of the world and there was definitely a need for an update. As noted above, for private companies there were previously only three options for legal entities: sole proprietorships, partnerships, and private limited companies. The new Limited Liability Partnership (LLP) essentially merges the flexibility of a general partnership with the advantages of a limited liability company. Ultimately, what that means is that no partner in a partnership will be held accountable for another partner's misdeed. The liability in an LLP is also limited to capital investment and not personal. An LLP is mainly a good option for firms operating in the ***services*** sector, like law firms and accountants.

What are the potential taxes applicable to my business?

The following are the most common types of taxes that could be applicable to you as an incorporated company, which include but are not limited to (We advise getting an accounting firm on board to help manage and navigate this):

★ **Withholding taxes** are paid by clients on behalf of the vendors on every sale;
★ **Income tax** has to be paid on every invoice of the business;
★ **Sales tax** has to be paid on every transaction that is in the domain of the nature of the product/services being sold;
★ **Payroll tax** and EOBI deductions need to paid on employee payroll;

- ★ **Consumption tax** is also levied on businesses on the consumption of goods and services via sales taxes (General Sales Tax);
- ★ **Bank taxes** are taxes levied by government and directly debited by banks from the bank accounts of companies which include but are not limited to Zakat deductions;
- ★ **Excise taxes** are levied on the import of goods.

Taxation can seem daunting, but let's use i2i as a case study. Invest2Innovate is a registered private limited company that essentially provides services (consulting mainly). As a services company, the main taxes that we worry about on a regular basis are withholding tax, sales taxes, and income tax, (which is paid on an annual basis).

How can I protect my idea? What's the process of registering IP?

The only legal step you can take to protect your idea in Pakistan is to register the intellectual property, i.e., the IP. While U.S. patents do matter most (in case you decide to register your IP in the United States), you can register your IP in Pakistan if you plan to operate in the country.

Here are the three types of IPs you can register:

- ★ **Trademark/brand name,** or the name of the business. This can be registered with the Intellectual Property Organization of Pakistan (IPO Pakistan), which can take up to a year and a half to confirm the final trademark certificate, though the application can be filed in a week.
- ★ **Copyright,** which includes all creative work, i.e. literary, artwork, source code, etc. Copyright registration takes two weeks with the IPO, and about six months for the final certification.
- ★ **Patents** are a unique/novel inventions of processes or products in any field of technology which is capable of industrial application, and can be filed in about a week's time with the IPO.

Bottom line: The process to register IP is long and can be hard to enforce in Pakistan, but here is a link to guidelines via the Small Medium Enterprises Development Authority, or SMEDA.

I don’t know the first thing about contracts. Where should I start?

First, whichever lawyer you decide to work with should be able to draft a contract for you depending on your needs and what it’s for. **Wukla**, a startup co-founded by our partner Mubariz Siddiqui, currently offers ***free*** customizable templates you can use, which include confidentiality agreements, partnership agreements, power of attorney, agency agreements, and permanent & contractual employment agreements. You can access that all here.

Can I offer shares to my employees?

There are no clear **ESOP** (employee stock option program) provisions for private companies in Pakistan. However, an ESOP can be created if the founders of the company allocate shares to the employees as and when the shares have been earned as per their vesting schedule. Your employment contract details the way you vest these shares (i.e., your contract can say your stocks vest over the next 5 years, 1% every year). You can structure this many different ways, but please speak to a lawyer about how best to structure it in your circumstances.

What do investors look for in their due diligence process?

If they're a serious investor, a lot. Due diligence can take a while depending on the investors, and with good reason, so be prepared to showcase all your financial documents, audits, legal documents, the list goes on. Investors will also often conduct independent research and due diligence on the market segment, which can take time given the lack of data in the Pakistan market (meaning they'll have to gather data themselves). Here are some of the major categories that investors look at in their due diligence process:

- ★ ***Business Organization:*** all formation documents & amendments, by-laws, articles of association & governing documents, organization structure charts, lists of all partners & shareholders, and copies of all SECP filings.
- ★ ***Business Finances:*** all audited and unaudited financial statements, grant agreements, any documents that show lines of credit or loans, details of any personal guarantees, security interests, lenders, etc.
- ★ ***Accounting:*** all accounting reports, any non-business related assets, and any and all income tax returns.
- ★ ***Contracts****:* copies and proof of <u>any</u> contracts the business has entered into with other parties.
- ★ ***Property & Equipment*****:** any proof if the business owns any property, equipment or assets.
- ★ ***Intellectual Property:*** any evidence and documents if the company has filed for or owns any intellectual property.
- ★ ***Employees:*** a list of all employees, their contracts, shares in the company, organization charts, employee manuals/handbooks, benefit/compensation offered to employees, etc.

What are the different types of investment I can accept?

There are two main vehicles for investment into a privately-held company in Pakistan, particularly for investors looking to make early-stage investments into startups:

1. **Equity**: also known as the buying and holding of shares in a company, in anticipation of income from dividends and capital gains, dependent on the performance of the company.

2. **Debt:** also known as a loan to a company, in which your profit is not directly related to the performance of that company. It is important to note that debt investments made by a foreign investor are heavily regulated by the State Bank of Pakistan, particularly the loan terms and the interest rates. You should speak to a chartered accountant to understand this further if you seek to raise from a foreign investor and understand these implications.

Can I accept a convertible note investment? What about a "safe" agreement?

Convertible notes are somewhat of a hybrid of the two vehicles noted above. Convertible note is debt taken by the company from an investor which will convert into equity based on the valuation of a company upon occurrence of a mutually agreed event or milestone (aka, a "trigger event"). This type of investment is ideal for startups, since valuations can be tricky and abstract at such an early-stage. **Convertible notes are not technically an investment vehicle recognized under Pakistani law**. However, convertible notes can potentially be done indirectly, **but please seek professional legal advice if you decide to pursue this path**.

Startups can also enter into a **"safe",** or a **simple agreement for future equity**, in which the money will convert into equity at a certain trigger event. This type of investment was conceptualized by YCombinator, one of the top incubators in the world. Unlike a convertible note, a safe is not a debt instrument; which, as pointed out above, have maturity dates, are subject to major regulations in the Pakistan context, and can have potentially negative consequences for startups. To read more about safes, see here, via YCombinator.

Bottom line: It is highly advised to speak to a lawyer before pursuing *either* of these options.

What is a 'valuation' and how do I value my company?

A 'valuation' is simply the value of your company in monetary terms. It is the total present 'price' of your company based on the money it will earn in the future and the assets it currently possess or will possess in the future. The assets may be physical (easy to quantify - for example if your business owns property/a factory, or machinery, etc) or they may be harder to 'price', such as the 'price' of your brand identity (there is a higher price if the brand is well-known), your founders and team (years of experience, depth of relevant experience, etc), the importance of your idea and how easy or hard is it for someone to copy it, etc.

Most people will value your company using a simple method called **'Discounted Cash Flow'**. This method looks at your projected income over a period of time and calculates the value of all future income for the present. There are approximately three methods most commonly used to value any company (DCF, comparable company analysis, and precedent transaction analysis, learn more here), and most people will use a mixture of these methods to arrive at the final valuation that they will start the negotiation process with. The **Motley Fool** has a nifty calculator you can use to get a basic idea, here.

Bottom line: Valuations are difficult to calculate for early-stage companies in Pakistan - first, because early-stage companies lack data and history to base calculations on, and second, because Pakistan lacks data to judge market size and future projections. In our experience at i2i, we've found that valuations are easier to defend the more data you have as a company; i.e., the longer you've been in business, because the number is grounded in reality versus an abstracted projection. Also, if you're able to use companies in other nearby countries as comparable examples, leverage that to strengthen your case.

Another bottom line: If you are a startup, investors should know that your valuation is loosely based, and it really amounts to how much control of your company you're comfortable giving up (and how much investors want to take). Be open to negotiations of course, but also keep a range in mind when you go into investor negotiations.

How much equity in my company should I be willing to give up to investors?

In Pakistan, we see founders too often give up too much equity very early-on in their journey as a company. ***Be careful***, because giving up majority stake or too much equity in your company when you are a startup makes it very difficult to raise investment from serious investors in follow-on rounds.

There are **four** tiers or levels of shareholder ownership:

1. **< 20% shares** gives an investor no special rights in a company.
2. **A minimum of 20%** gives an investor special minority shareholder rights in a company, i.e., the right to be able to petition company courts, etc.
3. **Between 26% and 50% shares** gives an investor the right to block special resolutions within the company, (since someone would need at least 75% shares/ownership in order to pass a special resolution).
4. **> 51% shares** give an investor the majority of shares in a company.

What does dilution mean? Do I need to pay attention to that?

Dilution is basically where a company is divided into smaller pieces, meaning that current investors have a smaller portion of the overall proverbial pie. For example, if your company is a pie that four people own equally, they each own 25% of the pie. When you add more owners, or if an investor comes in, the share of the original 4 gets smaller because the pie gets divided further - this is ***dilution***.

Here's an example via TechCrunch to illustrate this further: *If you own 20% of a $2 million company your stake is worth $400,000. If you raise a new round venture capital (say $2.5 million at a $7.5 million pre-money valuation, which is a $10 million post-money) you get diluted by 25% (2.5m / 10m). So you own 15% of the new company but that 15% is now worth $1.5 million or a gain of $1.1 million.*

Bottom line; This is why it's important to be careful with how much you give up in your first round of investment - you may think that it may not be a big deal to give up 50% of your company up front to an investor, but you need to keep in mind future rounds, because that 50% will continue to be diluted further and further, as will your rights as a founder. This is a problem when it comes to the control of the board and management of the company. It is also important to build clauses in your shareholders agreement that ensure that when further shareholders are brought on board the equity of all the older shareholders **vests**, including all investors.

Additional Resource: There are a lot of simple dilution calculators out there in the interwebs, so surf around, or check out this one here. Also check out this helpful infographic via Techcrunch to learn more here.

What is a term sheet? What should I pay attention when I receive one from an investor?

A term sheet is a nonbinding agreement that outlines the basic terms of an investment. Basically, it ensures that all parties agree on all aspects of the deal before a legally binding agreement is made.

Bottom line: a term sheet is not legally binding, but it does lay the groundwork for what is legally binding, aka your shareholders agreement (SHA). Here's a good guide on term sheets & a way to calculate their "founder friendliness" score.

There are two general things you should pay attention to when analyzing your term sheet: (1) **economics** and (2) **control**. The main provisions related to economics are the valuation, ESOP, vesting, liquidation preference, and any other terms that impact the finances of your company, such as dividends. The control provisions are usually related to things like board seats and reserve matters. If you receive a term sheet from a fund, for example, it may contain details like the amount of investment, the percentage stake they seek to take in your company, any anti-dilutive provisions, and the valuation of your company. Whenever you get a term sheet, we strongly advise that you share it with your lawyer (preferably a lawyer that has had experience negotiating for startups in the country), and get insights from experienced professionals to ensure that your rights are safeguarded. It is important not to make any hasty decisions and to think all the clauses through, including the possibility of raising further rounds of investment and understanding what happens to your cap structure when that happens.

What happens after I agree to a term sheet with an investor?

As noted above, a term sheet is a *non-binding agreement*; i.e., you cannot be taken to court on that document alone. The term sheet allows you to agree on and lay out all the terms of the deal. Once all parties agree, lawyers will use that to draft a **shareholders agreement, or SHA,** which will include all the legal language and the parties bound by the deal. The SHA is enforceable in a court under Pakistani law. Lawyers will also draft the Memorandum & Articles of Association, which are essentially the constitution of a company and are also legally binding.

Bottom line: As your SHA is drafted, make sure that whatever was in your term sheet is accurately reflected in the SHA and Articles of Association and that all provisions pertaining to economics and control are correct.

What is a vesting schedule? How does equity vest?

Vesting is simply a legal agreement that ensures that whoever is being put on the '***vesting schedule***' will fulfill their end of the bargain to 'pay for' their share of the company. Here are some situations in which vesting schedules are used:

★ **<u>Vesting among founders</u>**: As founders, it seems simple enough to just assign everyone equity right at the start of your entrepreneurial journey, especially if two or more people came up with the business idea together and set up the company. The problem that arises is if one or more of the founders later do not perform up to the standard expected of them, or no longer want to work for the startup. If they already have their equity share, it's easy for them to simply walk away with a piece of the company, without doing their fair share of work. This can cause a huge issue for the founders, and can be an issue in raising investment later on. If you create a ***vesting schedule*** from the beginning, it could state that all founders need to work full-time on the startup for 5 years, over the course of which their equity percentage will vest. The shareholders can decide milestones upon which vesting will occur, and can come up with very detailed terms (for example, if someone leaves the company before year 5 is complete, what do they walk away with?).

★ **<u>Vesting for founders at the time of investment</u>**: For investors, vesting schedules are a way of safeguarding their money. When an investor gives money to a company they can put the founder(s) on a vesting schedule to ensure that the founder will keep on working on the startup. It's crucial to understand that investors don't give money to ideas, they give money to founders. As in the case above (vesting among founders), investors also don't want founders to stop working on the company and still 'own' a piece in the startup.

★ **<u>Vesting for investors</u>**: There are some cases where investors promise a large sum of money but plan to give this out over a period of time. In such a situation, the investor can also be put on a vesting schedule, so equity is transferred to them based on the money they inject into the startup.

Want to learn more? [Here's]() a great resource on vesting, via The Next Web.

Anything else I should know?

Tons, we're sure. We wanted this guide to touch on some of the main questions we at i2i see with the startups we've worked with, but we're also very aware that there are a lot more questions you may have or will encounter in your journey as a startup. This guide is a living document, so please reach out to us with your queries so that we can incorporate them here, or find a good lawyer who can answer them for you and represent your interests best. **<u>We've created a nifty Google</u>**

document here with lawyers in different cities across Pakistan you can use as a reference, which you can access here.

Remember that knowledge is power and good luck!

About the Authors

KALSOOM LAKHANI, FOUNDER/CEO, INVEST2INNOVATE

Kalsoom Lakhani is the Founder/CEO of Invest2Innovate, or i2i, which supports startups and the broader entrepreneurship ecosystem in growth markets. i2i has been operating in Pakistan since 2011. Kalsoom has also trained young entrepreneurs, changemakers, and civil society leaders in Kosovo, Nepal, Cambodia, Ireland, Bangladesh, Ukraine, and Kazakhstan, and has spoken at numerous venues, including the World Economic Forum, U.S. Chamber of Commerce, U.S. State Department, the Global Entrepreneurship Congress, and the Global Entrepreneurship Summit. She was previously a Washington, D.C. co-ambassador for Sandbox, a global network of innovators under 30, (recently renamed the Thousand Network) and is a member of the World Economic Forum's Global Shapers. She was featured in Diplomatic Courier's Top 99 Foreign Policy Leaders under 33 in 2012, and was named an Ashoka Changemakers/ American Express Emerging Innovator for 2013. She has a B.A. from the University of Virginia in Foreign Affairs and Middle East Studies, and an M.A. from The George Washington University's Elliott School of International Affairs in International Affairs/Conflict Resolution.

MUBARIZ SIDDIQUI, INDEPENDENT LEGAL PRACTITIONER

Mubariz Siddiqui has been practicing law for 10 years and has previously worked at two leading law firms in Pakistan – Rizvi, Isa, Afridi & Angell and Orr, Dignam & Co. He had been involved in both contentious and non contentious matters. His areas of practice included project finance, mergers and acquisitions, and other matters pertaining to corporate and commercial advisory, labor, foreign investment and foreign exchange regulation, and competition law.

In August 2014, Mubariz started his own independent practice, which primarily focuses on startups and early stage businesses in Pakistan. Mubariz advises entrepreneurs and investors on various matters such as investment, corporate and commercial, labor laws, intellectual property, and product development in highly regulated areas. He also serves as an entrepreneur-in-residence at The Nest i/o, Karachi's leading technology incubator. Mubariz has represented and advised various startups raise investments aggregating more than US$5 million. His representative startup client list includes Keep Truckin, ProCheck, Sarmayacar, Sukoon, WonderTree, Investor's Lounge, Eat Mubarak, Sheops, CreditFix, Dreamnode Studios, and Mandi Express.