1992 IMPLICATIONS OF A SINGLE EUROPEAN MARKET

COMPANY LAW

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OF A SINGLE EUROPEAN MARKET

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This report was prepared by Fred Blaser of the Toronto office of Ernst & Young, for External Affairs and International Trade Canada (EAITC).

FOREWORD

The European Community (EC), with a GDP similar to that of the United States, is Canada's second-largest trading partner and source of investment and technology. Canadian companies therefore have a particular interest in the completion of the European Community's internal market. The goal of the Single Market program, or Europe 1992 as it is often called, is the complete removal of barriers to the movement of goods, services, labour and capital amongst the 12 member states of the Community to create a dynamic and rapidly growing market.

External Affairs and International Trade Canada (EAITC) is pleased to present this study as part of a series of reports on the implications of a Single European Market on Canada's trading, investment and technology interests. This series includes sectoral reports covering:

Agriculture and Food Products
Consumer Goods and Cultural Industries
Telecommunications and Computers
Automotive Industry
Minerals and Metals
Forest Products
Defence, Aerospace and Transportation
Specialty Chemical Products, New Materials, Pharmaceuticals and Biotechnology
Industrial Products and Services
Financial Services
Fisheries Products
Professional and Consulting Services -- Law and Accounting;

and policy reports concerning:

European Monetary Union
Company Law
Competition Policy
Intellectual Property
Standards, Testing and Certification

These reports, prepared by independent consultants and/or policy experts, analyze the trends, export impact, competition, investment implications, technological acquisitions, and political and legal implications arising from the EC Single Market of 1992.

This series of reports complements an earlier study published by EAITC, *1992: Effects on Europe*, which details the major economic and trade effects of the integration. Now in its third printing, the report provides a clear picture of the harmonizing legislation and implementation measures, and the general expectations and response of European industry.

Subsequent to these reports, EAITC will focus on subsectors of Canadian industry in which particular opportunities arise from the Single Market. These studies will go into much more detail on the trade ramifications specific to each subsector.

Together, these reports, the overview presented in *Effects on Europe*, the sectoral analyses of this series of studies, and the subsector details of the next phase of Europe 1992 reporting are not simply an information base for Canadian business people, but can be seen as a call to action. Europe 1992 is happening now. It will affect the way we do business. We have to know about it. And we have to plan to profit from it.

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EXECUTIVE SUMMARY

In the European Community (EC), rules governing the establishment and organization of business operations, direct and indirect taxation, technical standards and the free trans-border movement of goods are generally more complex and less uniform than those in Canada. This report examines the ways in which the EC is moving to harmonize these and other laws. Canadian investors must recognize, however, that the national laws of member states continue to apply to many operations and transactions within the Community and that these laws tend to vary more than do comparable rules within Canada.

For example, an investor establishing a commercial enterprise in this country can do so by incorporating under rules set out in the Canada Business Corporations Act, regardless of the province or provinces in which the enterprise operates. Moreover, the corporate rules of several provinces, namely Alberta, Ontario, Manitoba and Saskatchewan, are substantially similar to those contained in the federal statute. As far as fiscal factors are concerned, roughly two-thirds of all corporate tax collected in this country is collected under uniform federal rules, with provincial corporate systems accounting for the remainder.

For the most part, the EC uses harmonization as the main instrument for creating a Community-wide set of rules to govern various business activities. Harmonization means that the EC will enact a set of general rules, which individual member states will incorporate into their respective national laws. This is true, for example, of the Community's rules governing the disclosure of corporate information or the use of specified accounting practices. Many such rules will impose minimum standards, leaving each country free to impose stricter rules. This approach still allows some variation in the way each country implements and enforces Community law. Nevertheless, the evolution of business law in the Community is clearly moving toward a common, EC-wide set of minimum standards.

More ambitious is the goal of creating a system of company rules that would be defined by the Community itself. Such rules would not need to become part of the national law of any member state, and their creation would ensure to the highest possible degree that companies are subject to identical administrative treatment, regardless of where they are located within the Community.

In this regard, the European Commission has proposed a European Company Statute, which would allow, for the first time, the creation of a truly European company. The statute would govern all major aspects of company incorporation and organization, including formation, capitalization, administrative bodies, employee participation, tax residence and fundamental changes. Negotiations are continuing at this time, however, to design a version of the statute that will be acceptable to all member states. Developing extensive Community-wide systems in this area will be a major challenge for member states during the 1990s.

The European Company, once it exists, will be an optional vehicle for investors seeking the corporate structure that best reflects their business needs. For companies that plan to do business in more than one EC member state, a major advantage of using a European Company, as in the case of a federal company in Canada, will be the elimination of any need to incorporate individual companies in different jurisdictions, each having somewhat different corporate rules.

Some companies may also perceive that incorporation as a European Company conveys greater status in world markets over a company that is only incorporated in a single country. Similarly, investors, especially foreign investors, may feel that incorporation at the Community level could offer them greater protection than if they were to be at the whim of a single country's lawmakers.

For other companies, particularly those with smaller, more local business operations, incorporating as a European Company may be unnecessary or undesirable. Depending on the cost and complexity of incorporating in a particular EC member state, national incorporation may be the preferred option. This is particularly important in the event that national administrators or legislation is more responsive to the firm's needs than that at the Community level.

Innovative proposals are worth discussing as they relate to the carrying on of business in the Community; new tax rules have increased the attraction of a Community subsidiary (as opposed to a branch) as a business structure, and a newly created alternative to conventional joint ventures, the so-called European Economic Interest Grouping, offers investors the advantages of a separate legal entity, simple formation rules and a uniform structure throughout the Community.

While many similarities exist in the company laws, respectively, of Canada and the EC, the existence of specific rules points to a more highly regulated approach to business than Canadian investors will generally have experienced. For example, companies incorporated in most EC member states must specify the types of business operations they will carry on. Companies proposing to merge must arrange for independent audits of their respective assets. Disclosure rules for small companies are more onerous.

The report examines these and other recent developments in the areas of company law, tax and management-employee relations and reviews the major administrative and tax considerations that a Canadian investor would analyze before establishing a Community operation.

I. INTRODUCTION

As the European Community[1] moves closer to the creation of a single, integrated market, several factors make the Community a more attractive location for direct investment by Canadians.

The reduction or removal of barriers to internal trade and investment will help make the Community a more efficient economy. As such, it will have higher levels of demand for quality goods and services, including those offered by Canadian suppliers. Much has already been accomplished in this area, especially since the launch of the Community's Single Market Program -- Europe 1992 -- which seeks to eliminate obstacles to the movement of people, goods, services and capital by implementing some 300 proposals for the harmonization of national laws.

The harmonization of rules governing the way business can be carried on in the Community will make it increasingly convenient for Canadians to establish, organize and administer businesses in the EC. Another potentially attractive consideration for Canadians looking at EC business opportunities is the Community's growing economic integration with the countries of the European Free Trade Association -- Austria, Finland, Iceland, Norway, Sweden, Switzerland and Liechtenstein -- through the creation of a European Economic Area. Finally, the EC can serve as a springboard for Canadian businesses interested in the emerging markets of Central and Eastern Europe.

This report focuses on the way in which EC company law is becoming increasingly harmonized and on the implications that such harmonization has for Canadian businesses interested in supplying products or services to the Community. The report also summarizes important developments in related areas, particularly tax and labour-management relations. The scope of the report does not permit a review of such related areas as securities regulation or bankruptcy law, or of issues such as harmonization of technical standards or government procurement practices. Similarly, the report does not deal with rules governing the provision of financial services, since specialized rules apply to this sector.

These developments do not mean that an investment by a Canadian company to acquire a Community-based operation is recommended in every case. In some instances, the appropriate strategy for a Canadian producer seeking a Community market for its goods and services is exportation, not investment. There has been much comment in recent years about whether the Community is likely to transform itself into "Fortress Europe" -- and indeed there are ways in which the EC effectively excludes or discourages imports. For example, Community producers launch more anti-dumping and countervailing duty actions against foreign products than does any other jurisdiction.

At the same time, the thrust of the Single Market Program is to implement economic reforms that will benefit producers and service suppliers, regardless of whether or not they are Community residents. This is because there is a basic difference between what can be called first-stage and second-stage trade liberalization. The Canada-United States Free Trade Agreement is an example of a first-stage reform. The most important element of such reform is mutual tariff elimination, which tends to cause diversion of trade, away from producers in third countries.

In contrast, the Single Market Program is a second-stage process, the most important element of which is harmonization of national rules. Often, non-Community suppliers can take advantage of such harmonization. For example, foreign producers benefit from the adoption of simplified customs procedures for goods moving between EC member states, in the same way that their Community counterparts do. Likewise, Canadian exporters to the Community will be able to take advantage of the efficiency that comes from elimination of internal border posts, once value-added taxes are harmonized among Community countries.

A Canadian enterprise that believes it has a strong potential market in the Community will, accordingly, have to determine whether or not a combination of tariffs, possible anti-dumping actions, exclusion from government procurement or other trade barrier could harm its chances of succeeding as an exporter to the EC. If governments are a potentially important buyer, an EC operation may be vital in order to obtain preferential treatment under local or EC procurement rules. The answer to such questions will in each case be based on factors that apply to the particular product or service involved.

The issue of whether to export or invest will also depend on commercial considerations. The nature of a particular industry in the Community may be such that a supplier has a better chance of market acceptance if it has a Community presence. Similarly, special market characteristics -- consumer demand, just-in-time requirements or other factors -- may tilt the scales in favour of a Community-based operation.

For Canadian businesses that are considering that an EC-based operation is the preferred way to penetrate the Community market, this report summarizes major developments in the evolution of a single system of company law and related rules. The report identifies benefits and costs associated with various types of investment approaches and, since the harmonization process is far from complete, discusses key proposals for additional changes in this area and their likely eventual impact for Canadian investors.

Disclaimer

This report is an overview of current and proposed company laws and related rules in the EC, designed to assist company executives understand the emerging regime. This report represents one of several sources of information in this area. Readers are advised to consult additional sources and expert advice for purposes of establishing or organizing a specific Community enterprise.

II. RULES

This section of the report canvasses the principal Community and national rules, which would affect a Canadian investment in the EC, points out key differences between Community and Canadian approaches and makes recommendations, where appropriate, as to potential investment strategies.

1. Where to locate

The first thing a Canadian company will do, when proposing to make a direct investment in the Community, is to determine in which Community country or countries it proposes to become established.

a) Commercial Issues

The company must consider all commercial factors, including proximity to target markets, availability of suitable technical and managerial personnel, and costs of plant, labour and other production factors.

b) Regulatory Issues

The company must also consider regulatory factors, including tax obligations and rules governing a variety of business operations, from investment incentives to labour-management arrangements. Although harmonization is occurring in many of these areas, national laws continue to apply where EC-wide rules do not yet exist. Depending on the Canadian company's tax position, objectives or management style, some Community member countries could well be more attractive investment destinations than others.

c) Right of Establishment - General

Among the regulatory issues a Canadian investor must consider before investing is whether or not a foreign-controlled business has the right to carry on a proposed activity. There is no Community-wide restriction on the rights of non-Community residents to do business in the EC. A prospective investor must, accordingly, examine the restrictions on foreign investment imposed by individual countries.

All member states restrict foreign direct investment, at least to some degree, in sectors that affect national security -- for example, certain types of defence-related production. In addition, France prohibits foreign direct investment that competes with state monopolies, while special formalities must be complied with in sensitive sectors such as publishing, oil-gas and pharmaceuticals. Germany prohibits foreign investment only in the postal service, a monopoly that includes telecommunications, while the U.K. has lifted all restrictions on foreign-controlled investment by private investors.

d) Right of Establishment - Services

Generally, national rules governing establishment apply to service providers in the same way they apply to goods producers, with one important difference. A foreign business that proposes to use its own nationals to supply services through an EC operation must first ensure that such persons have the necessary qualifications to practice their profession. Thus, a Canadian engineer might have to get local accreditation, although a software designer would likely not have to do so.

To give itself the greatest flexibility in these circumstances, a Canadian service company planning a Community operation could, where appropriate, consider designating one or more of its EC staff as managers, rather than as practitioners of a profession. An alternate way of solving the accreditation requirement could be to have a Canadian professional do most of the work involved in a particular case and to have this work certified by a locally qualified practitioner.

Non-EC residents will generally have to obtain a work permit, on a country-by-country basis, if they expect to earn income from services provided in the EC. On the other hand, Community-resident employees of an EC-based service company controlled by a Canadian investor are allowed to work freely in any member state.

2. Preliminary Considerations

Having decided where in the Community to locate its investment, a Canadian business will next consider several preliminary issues.

a) Protecting Intangibles

A Canadian business planning to carry on EC operations will typically seek to protect two intangible assets -- its intellectual property and its business name. It should be noted that except in specialized cases, such as broadcast retransmission, no Community rules exist in relation to the protection of copyright, although proposals are under way in such areas as computer software.

b) Business Name

No Community-wide system of registration and protection exists in relation to business names. This means the investor must apply for the right to register and use a particular name in each member state in which it intends to do business. An investor who incorporates a subsidiary or registers a branch in a Community country will be advised in either case as to whether the name is registrable. If it is, the name will be protected in that country once registration occurs. No business name can be protected simply through name registration; at least a minimal commercial operation must be established.

c) Trademarks

Rules concerning trademark registration, use and protection are still governed by the national laws of each member state. However, a new Community-wide system of rules has been adopted, which will be in force not later than the end of 1992. Although the First Trademark Directive will harmonize national rules in several important ways, national rules in this area remain important.

A particular concern for any Canadian company seeking EC trademark protection is that, while in some member states registration amounts to effective assurance that the trademark in question belongs to no one else, in other states registration does not include an automatic trademark search, and such protection is therefore not granted. A related problem is that some member states grant protection to trademarks acquired by use. To prevent a possible action for revocation and damages in such countries as a result of failure to discover competing marks, an experienced private-sector agency should be used to do a thorough search.

National laws also apply to trademarks in other respects, including the right to establish administrative procedures for registration and revocation of marks and to determine the effects of revocation or invalidation. In most other aspects, however, the Trademark Directive is a significant harmonizing feature. Under the Directive, a trademark will, as now, be valid only in the individual countries in which it is registered. The Directive will, however, considerably increase uniformity and predictability in this area for Canadian and other investors by establishing a set of common rules to be followed by each Community member.

Specifically, the Directive defines a trademark and governs the kinds of signs that cannot constitute a mark and the grounds for refusal of registration and for revocation, among other issues. The Directive also provides that a trademark can be licensed anywhere in the Community, on an exclusive or non-exclusive basis, for any territory on which the licensor and licensee jointly agree.

A significant benefit for Canadian and other trademark owners is that the national laws of many member states do not require trademark holders to use their mark before registration. Accordingly, in these countries, a Canadian trademark owner can register its mark in several Community countries even before it plans to use it in a particular area. The Trademark Directive will not change this entitlement.

On the other hand, the Directive provides that if an owner does not actively use the registered trademark for a period of five years, the mark's registration can be revoked. Less strict Canadian law in this area allows a 15-year period before a trademark registration must be renewed and does not require proof of use in order to obtain a renewal, although non-use can result in a challenge to the mark.

Since the Directive does not change existing rules whereby a trademark is granted on a national basis, a company seeking EC-wide protection must go through the expensive process of registering 12 times or risk losing the right to its mark in any EC country in which it fails to register. To solve this problem, the EC has proposed a draft Trademark Regulation that would be valid and uniform throughout the Community. General agreement exists among member states as to the content of the proposed Regulation, which may be adopted in 1991. Major disagreement focuses mainly on where the Community's office for trademark administration will be located.

Under the proposed rules, Canadian companies and other non-EC residents could own a Community trademark. The draft Regulation defines a Community Trademark and eliminates confusion between registered trademarks and those acquired through use by requiring all EC marks to be registered. Registration, which would be made through one central office, would last 10 years.

d) Patents

Although no Community-wide rules exist for the issuing and administration of patents, most EC member states -- except, so far, Denmark, Ireland and Greece -- are signatories of a European patent treaty generally referred to as the Munich Convention, which came into force in 1977.

Under the Convention, a single patent application can be filed, with one set of rules for approval or rejection. An approved patent can then be registered in any country that is a signatory to the Convention. The application can be in any language approved by the European Patent Office. Conveniently for Canadian companies, these include English and French, as well as German. However, a signatory country may subsequently require the recipient to translate the text of the patent award into its own official language.

The Munich Convention governs what is patentable (that is, what is new and inventive), the term of a patent (generally 20 years, as in Canada, with exceptions allowed for some food and drug products) and the procedures for application, examination and opposition. Otherwise, the national laws of each country continue to govern important issues; for example, when does compulsory licensing apply, what is infringement, how quickly must an infringement action be brought, what is the burden of proof that must be met and what remedies are available?

Since substantial differences can exist among EC member states in these areas, the Community wants to establish greater harmonization. To this effect, it has proposed a Community Patent Convention, which would incorporate and build on many of the rules contained in the Munich Convention, while creating a uniform code that deals with the problems referred to above.

During 1991, an EC conference on this subject will submit the terms of the Convention to member states, each of which will have the option of ratifying it. EC case law has restricted the extent to which patent laws in different member states can allow different restrictions on the marketing of patented goods between jurisdictions. Canadian companies should recognize, however, that if any EC country chooses not to ratify the EC Patent Convention and instead continues to rely on its national law in this area, they may be able to benefit from such differences -- or their competitors might try to do so.

3. Choice of Business Organization

The next major issue confronting the parent company is the choice of the business organization it will use.

a) Branch versus Subsidiary

A basic question for a Canadian investor considering an EC operation will be whether to incorporate a subsidiary in the Community or simply to establish a branch operation. In most cases, a subsidiary will be preferable.

The branch form of doing business in the Community has several attractions, the most important of which is a lighter burden of formalities such as registration, record-keeping and the publication of accounts. As well, losses incurred in early years can be consolidated against parent-company profits. However, these tax benefits may not ultimately be significant if, depending on the country in which the branch is located, branch assets are subsequently transferred to a subsidiary and a taxable gain is realized as a result of the transaction.

Even though a subsidiary's accounts can not be consolidated with those of its parent company, loss carry-forward rights will at least allow the subsidiary in most cases to offset early losses against later profits. At the end of 1990, moreover, the EC proposed that loss consolidation should be allowed in cases involving a parent company that owns at least 75 per cent of the voting shares of a subsidiary.

In addition, an important tax change adopted by the Community in 1990 substantially eliminates a fiscal advantage that branches previously had over subsidiaries in cases involving remittances of profits between two EC countries. Under the new rule, no member state can withhold amounts greater than 5 per cent of dividends paid by a subsidiary to a parent in another member state. A branch is generally not subject to withholding or to an equivalent tax, in relation to profits remitted to its head office in another Community country. This issue is discussed in greater detail in Section V-1 of this report.

Other factors favouring the subsidiary form of doing business in the Community include the fact that, as in Canada, a parent company is liable for its branch's liabilities up to the limit of the parent's authorized capital. A subsidiary's liability is limited to the value of its own assets, since it is legally recognized as an entity separate from its parent. In some cases, moreover, a foreign investor will find that incentives offered by an EC member state for the establishment of a new business operation are available only to companies that are incorporated in the particular country.

Finally, one of the main reasons a Canadian business usually establishes a Community presence is to send a message to prospective customers that it has a commitment to the local market. Incorporation will generally convey this message more vigorously than the establishment of a branch operation.

b) Branch Operation

In cases where a Canadian investor decides to establish a Community branch, presumably because registration and related procedures are simpler and the investor is not yet sure that its EC operations are likely to expand enough to warrant incorporation, the branch will generally have the same rights as a subsidiary to own assets, employ personnel and carry on business activities in the Community. A new set of rules were adopted by the EC in 1989, and will be implemented as of the beginning of 1992, that harmonize on a Community-wide basis the type of business information a parent company must disclose in any member state.

Previously, different disclosure requirements among various member states -- some countries required extensive filings; others only that annual financial statements be submitted -- created a patchwork quilt for investors. In contrast, under the provisions of the Eleventh Council Directive, a branch established in any member state must file specified information, including its address, a description of proposed activities, particulars of persons authorized to represent it in business dealings and the financial statements -- balance sheet and profit-loss account -- of its parent. These rules apply regardless of where the parent company is incorporated.

In addition, a branch of a Community-resident company must identify its parent and the country in which the parent is registered. The Community branch of a non-EC parent must also file copies of the parent's articles of incorporation or equivalent documents and particulars of its issued capital.

c) Subsidiary

In most instances, a Canadian company seeking to establish a Community business operation will do so through a locally incorporated subsidiary. The precise type of subsidiary used will depend on the national law of the country of incorporation. Regardless of where it incorporates a subsidiary, a Canadian parent company will be able to choose between two basic options: a public corporation, (that is, one that has the right to distribute its shares to the public and that may or may not be listed on a stock exchange) and a private corporation, with restrictions on its rights to transfer shares.

Most medium-sized and smaller Canadian companies are likely to prefer the latter option, since a closely held company will in most cases encounter simpler registration and operating requirements than will a company with the freedom to distribute shares -- for example, the right to have only one director.

Although some differences in form and function exist between, for example, a U.K. limited company and a German Gesellschaft mit beschrankter Haftung, these corporations and their counterparts in other EC member states offer Canadian investors the same basic attributes as those under the Canadian system: the existence of an independent legal entity, the right to own property, the power to sue and be sued, limitation on shareholders' liability and perpetual existence.

Under current EC rules, the company law of each member state must conform to the minimum standards established in EC directives governing disclosure and other matters. Rules governing the actual process of incorporation in any EC country, however, are established by the particular member state. As a result, a substantial amount of variation continues to exist, in relation to forms used, formalities that must be observed, and times and costs of incorporation. The following information illustrates the incorporation process of private limited companies in selected countries.

i) Germany: The corporate constitution drawn up by the investors -- equivalent to the articles of incorporation used in most Canadian jurisdictions -- must be notarized. It is then submitted to the trade registrar of the court in the district in which the company will have its principal place of business. At this time, the investors must pay a capital tax equal to 1 per cent of the proposed corporation's paid-up capital (at the time of registration). Confirmation of the company's registration generally takes about 60 days. The costs of incorporating a small, closely held company, aside from capital tax and any fees paid to advisers for services other than incorporation formalities, generally range from DM4000 to DM5000, equivalent to about C$3000 to C$3800 (as at the end of 1990).

ii) France: A private company in France must register its articles of incorporation with the office of the commercial court in the district in which its principal place of business will be located. Registration requirements include a stamp or registration tax, publication in the legal gazette and a commercial registration fee. The cost of these formalities is about 6000 francs or about C$1300 at current exchange rates. A capital tax is also payable, at the rate of 1 per cent of paid-up capital. Confirmation of corporate registration usually takes 30 to 60 days.

iii) United Kingdom: To incorporate a private limited company in England (formalities may be slightly different in Scotland and Northern Ireland), the investors must register the articles of association (equivalent to articles of incorporation) and the memorandum of association (equivalent to company bylaws), paying a fee of L50 (about C$115 at current exchange rates) to the registrar of companies. A capital tax is also payable, at the rate of 1 per cent of paid-up capital. If all documentation is in order, the registrar can incorporate the company immediately.

d) Joint Ventures

Another common approach by Canadian companies considering a Community presence is to establish operations jointly with an EC-resident entity. While the range of potential business relationships is unlimited, from a legal viewpoint any possible arrangement must fall within one of three categories.

First, the arrangement may take the form of a new corporation, in which case it will be governed by the rules described in this report that are applicable to a subsidiary established in a Community country, as well as by local company law.

Second, a preferred arrangement for Canadian companies wanting to benefit from local expertise, lower risk and organizational informality will often simply be a contractual agreement -- shared-cost production, distributorship, licensing arrangement and so on -- that creates no independent legal entity. In such a case, no Community-wide rules would apply. Instead, the venture would be governed exclusively by the national business rules of the country in which it carries on its operations. Alternatively, the arrangement may be a partnership, either because the parties designate it as such and register it under local law or because the particular national law deems it to be a partnership. Local partnership and tax rules will apply in either case. A more detailed review of strategic partnering is contained in the study, *Moving into Europe* (EAITC, 1991).

Third, Canadian investors interested in a joint venture agreement that involves operations in more than one member state may be able to benefit from a new set of rules implemented by the Community in 1989, which allow the establishment of a so-called European Economic Interest Grouping. A Grouping, described in greater detail in Section IV of this report, can be a useful mechanism for EC subsidiaries of Canadian companies that want to establish co-operative operations with other Community-based enterprises.

4. Disclosure

Important progress has been made to ensure that a single, Community-wide system of rules applies to the requirements for disclosure of key business information, for protection of shareholders and creditors. Will the co-ordination of national rules in these areas, companies do not have to shop among competing jurisdictions for business rules that may be preferable. Instead, decisions are made principally for business reasons. At the same time, member states have the assurance of knowing that shareholders and creditors will have equal protection from companies with which they deal, regardless of which member state a particular company happens to be incorporated in.

The extent of disclosure varies, depending on the type of entity involved. Disclosure for public limited companies, regardless of whether or not they are listed on a stock exchange, is governed by the Second Council Directive, which emphasizes disclosure of corporate finance information and is described in greater detail in the next section of this report.

The First Council Directive, with its less onerous rules, governs both private and public limited companies. Under the First Directive, all member states must ensure compulsory disclosure of -- at a minimum -- several basic items of information, including the company's articles of incorporation and bylaws, with all subsequent amendments, and the particulars of persons authorized to bind the company.

Annually, the company must file its issued capital and financial statements, the latter consisting of a balance sheet and profit-loss account. Under EC rules, filed documents are kept in a register, which is available to members of the public.

As well, the Directive provides that each member state's law must make individuals liable if they enter into pre-incorporation contracts on behalf of a company that is not ultimately incorporated. For its part, a company will generally be liable to third parties for any obligations it incurs that are outside its scope of activities. Canadian companies, most of which are incorporated in jurisdictions that no longer restrict their scope of permitted activities, should, when incorporating an EC subsidiary, provide as broad a list of objectives as possible. This measure will avoid the need subsequently to amend the subsidiary's articles and corporate filings.

5. Corporate Finance

Community law dictates no minimum capital requirements for private companies. Instead, this issue is dealt with under each member state's national law. The U.K., for example, has no minimum capitalization rule, while most other EC countries do. Nor does the First Council Directive establish a code for the issuing and redemption of corporate securities or any rules for share purchase arrangements.

In contrast, the Second Council Directive has extensive rules in these areas, on the theory that public limited companies tend to carry on more trans-border activities and have more shareholders and creditors in need of uniform protection. In particular, the Directive says that member states must have certain minimum disclosure rules regarding a public company's shareholdings, including the number and value of issued par-value shares or, where national law allows no-par-value shares to be issued, the number of such shares. Additional information to be disclosed includes rights attaching to shares issued in more than one class and any privileges granted to persons who have participated in the company's formation. These requirements are stricter than those typically imposed by most Canadian jurisdictions, in which private companies generally need not publish information about the nature and value of their shareholdings.

Another EC rule not generally imposed in Canada is contained in the Second Directive requirement imposing a minimum capital requirement for public companies of 25 000 European Currency Units (ECUs), the equivalent of about C$40 000. On the other hand, Community rules are more relaxed when it comes to purchase terms, insofar as that only 25 per cent of the nominal share value must actually be paid at the time of incorporation. The balance need never actually be paid up, although shareholders must contribute the balance in the event that the company becomes liable for the full amount of its subscribed capital. These payment terms differ from the rules imposed in most Canadian jurisdictions, where shares must be 100 per cent paid up as of the date of issue, regardless of whether the consideration is cash or kind.

Non-cash share purchases must be 100 per cent completed within five years of incorporation. An additional Community safeguard in the area of non-cash payment for shares involves the requirement for an independent expert to submit a report describing the assets contributed and the method of valuation.

Community corporate finance rules tend to be restrictive as well, compared with most Canadian jurisdictions, in relation to the right of public companies to redeem their own shares and to issue additional shares without first offering them to current shareholders, in proportion to the number of shares they already own. In Canada, companies generally have the power to acquire their own shares, subject to solvency concerns or a prohibition in the articles of incorporation. In addition, Canadian corporate directors generally have discretion to issue additional shares, without offering them to existing shareholders on a pre-emptive basis. The Community approach in these areas reflects an administrative philosophy that differs somewhat from the one that prevails in Canada -- emphasizing the protection of rights rather than corporate freedom of action.

Under the Second Directive, shareholders must approve any reduction of the subscribed capital of a corporation, and creditors with claims that pre-date publication of a decision to reduce the subscribed capital can demand security for their claims -- a right Canadian creditors generally do not enjoy. No reduction can be made that would reduce a company's subscribed capital to less than 25 000 ECUs. As well, limits exist on the right of a company to distribute dividends to shareholders. A distribution of dividends cannot result in a fall of the value of remaining company assets below the amount of subscribed capital plus a small reserve, nor can it exceed the amount of accumulated profits.

Rights of companies to issue, redeem and otherwise affect debentures are dealt with exclusively under the national laws of member states.

6. Directors and Officers

Little progress has been made to date regarding the harmonization of laws governing the powers and responsibilities of directors and officers. These rules continue to be found under the national laws of member states. As a general rule, liability questions of directors and officers will arise less often than is the case in Canada, since their discretion tends to be more limited.

As far as the need to elect resident nationals as company directors is concerned, unlike most Canadian jurisdictions, no Community member state requires that any company administrator be a local resident. As a practical matter, a large EC subsidiary of a Canadian parent will almost certainly elect national residents to its administrative board, in order to benefit from their credibility and reputation. A smaller subsidiary, however, will often find it convenient to dispense with local administrators.

An important issue for Canadian investors establishing a Community operation will be the type of board that its subsidiary can have. Currently, national rules of the state of registration will determine the type of board that both a private and a public limited company can have. Private limited companies in each state can have an administrative structure that is even simpler than that required in most Canadian jurisdictions. This consists of as little as a single director, who is also responsible for managing the company's affairs.

More difficult issues arise in relation to public companies. Indeed, a major Community concern is how to harmonize the administration of such enterprises. Several member states favour a two-tier structure, such as that required under German law, in which a management board is responsible for the company's day-to-day affairs, while a supervisory board reviews the activities of the managers. A variation on this approach is a one-tier board, which includes both managing and non-managing directors, with the latter supervising the former.

The reason for this preference is the view among most EC member states that all public companies should have the objective analysis that comes from directors who are not part of the company's everyday operations. This view is commonly shared in Canada, too. A public company incorporated under the rules of the Canada Business Corporations Act, for example, must have a minimum of three directors, at least two of whom must be outside directors. In Ontario, at least one member of a public company board must not be a member of management. The U.K., on the other hand, objects to an arrangement that would prevent a public company's directors from also being its officers, without regard to whether such an arrangement might be best for that particular organization.

Differences of opinion over this issue have so far prevented agreement on a proposed Fifth Council Directive, which would create a compulsory requirement for non-managing directors of public companies in either a two-tier or one-tier structure. Agreement on the Fifth Directive is also being held up by failure to agree on employee participation in corporate management. The latter issue is addressed in greater detail in Section VI of this report.

7. Financial Record-Keeping

a) General

An area in which Community procedures have become harmonized to a considerable extent involves the form and content of financial statements and reports on corporate operations. This co-ordination reduces the extent to which competition for investment could occur among member states as a result of different reporting requirements. In addition, investors and creditors benefit from being able to deal with a single set of rules in this area.

These Community-wide rules, found in the Fourth, Seventh and Eighth Council Directives, contain few complications for Canadian financial officers. They will, however, represent an unfamiliar degree of disclosure for many private companies, which may not have to file financial statements as part of the public record, depending on the jurisdiction under which they are incorporated.

Under these Directives, private and public limited companies must annually prepare a balance sheet and profit-loss statement, together with accompanying notes. The financial statements must use the same format each year or explain any variance in the notes. Both the balance sheet and the profit-loss account must be prepared using specified layouts; two options are generally available for the former, four options for the latter. Simplified obligations are allowed for smaller companies, defined as meeting two of three criteria: assets not exceeding 1 million ECUs, revenues not exceeding 2 million ECUs and employees not numbering more than 50.

Likewise, valuation methods cannot vary from year to year. Valuation generally must be based on purchase price or production cost, although some member states require or allow use of the replacement value method to establish the value of inventories or fixed assets. This method allows asset values to adjust for inflation. Fixed assets must be depreciated over the period of their useful life. Either purchase price or production cost of interchangeable goods may be calculated on the basis of weighted average price, or by the first-in-first-out, last-in-first-out or comparable method.

Notes to financial statements must describe the valuation methods used and identify company obligations that are long term (more than five years) plus any secured obligations, together with the amounts paid and committed to officers, managers and supervisors.

In addition, the company must prepare an annual report, which, along with its financial statements, must be published in the member state in which the company is registered, as required by national laws. A private or public company registered in an EC member state generally must file consolidated financial statements, including information relating to any subsidiary it effectively controls. A subsidiary in an EC member state of a Canadian parent would not, however, be required to submit consolidated financial information with regard to its parent company.

b) Auditing Requirements

Under EC rules, private as well as public companies must have their financial statements audited, although individual countries have the right to waive this requirement. Likewise, Community law allows member states to exempt small companies from the audit requirement. To the extent audits are needed, this will amount to an additional degree of intervention and cost that some private companies in Canada do not face.

c) Consolidated Accounts

In the Community, as elsewhere, corporate expansion often takes place in such a way as to create spin-off subsidiaries, which nevertheless have unified decision-making at head office. To give an accurate financial picture of company groups in these circumstances, the Community's accounting rules generally require consolidated financial statements to be prepared whenever a company registered in the EC effectively controls the management of another company, wherever the latter is located.

Member states can exempt smaller companies from the consolidation requirements if they meet at least two of three conditions: asset value not exceeding 4 million ECUs, sales not exceeding 8 million ECUs, and employees not exceeding 250 in number. The rules governing preparation and publication of consolidated accounts are essentially the same as those that apply to individual companies.

d) Auditing Standards

To ensure a universal standard for the review of financial information, the Eighth Council Directive governs the eligibility of auditors on a Community-wide basis.

8. Corporate Reorganizations

a) Mergers within a Single Member State

Once a subsidiary of a Canadian parent is established in the Community, it may want to acquire another business. To create common standards in this area on a Community-wide basis, the Third Council Directive deals with safeguards that apply to mergers occurring within a single member state. In such cases, the Directive sets out minimum rules, which each member state must incorporate into its national legislation. These rules apply whenever a public limited company is wound up without going into liquidation and transfers all its shares to the acquiring company in exchange for shares of the latter.

The Directive also governs consolidation or amalgamation, in which two or more public companies are wound up, transferring their assets and liabilities to a new company, in exchange for the issue to their shareholders of shares in the new enterprise.

Before a merger, the merging companies must prepare a report identifying the companies, the share exchange ratio and profit participation, and the rights of holders of each class of shares in the acquiring company. This report must be published at least one month before a general meeting of shareholders of each merging company is called to approve the proposed merger.

In addition, independent experts -- usually accountants or lawyers -- representing each of the companies involved must review the terms of the proposed merger. The experts in turn must report to the shareholders, advising, among other things, as to whether the share valuations and ratios are reasonable. This is a safeguard not required under the company law of most Canadian jurisdictions, which makes company directors responsible for assuring proper valuations.

To obtain approval, from either the acquiring company or the target, a two-thirds majority of voting share or subscribed capital is needed, unless shares are voted that represent at least half of the subscribed capital. In such a case, only a simple majority is required. As well, the terms of any debentures issued by a party to a merger may give holders the right to approve or disapprove of the proposal.

Member states establish their own criteria for the protection of creditors whose claims pre-date a merger. In this area, the Directive provides only that creditors in each member state must be given adequate protection. Creditors include debenture holders, except in cases where they have specifically approved the merger.

The Merger Directive also provides for simplified procedures in cases involving the acquisition of a subsidiary by a parent company that holds at least 90 per cent of the subsidiary's voting shares.

b) Cross-border Mergers

A proposed Tenth Directive would govern mergers involving public limited companies registered in different EC member states. Currently, differences in national merger rules complicate such transactions, requiring would-be merging companies to deal with a patchwork of local laws. For example, some member states impose prohibitive restrictions on such potential mergers, including requirements for unanimous shareholder approval.

c) Takeovers

Community law is still evolving in relation to uniform treatment of takeover bids, but major philosophical differences among various member states have prevented the establishment of a Community-wide set of rules in this area. Several EC countries, notably the U.K., support aggressive business acquisitions as an effective way to build competitiveness. To encourage takeovers, there must be limitations on defensive measures that target companies can take. Germany and the Netherlands, on the other hand, believe hostile takeovers are counterproductive, and, accordingly, they support the retention of effective takeover defences.

As a compromise solution, recent amendments to a proposed Thirteenth Directive governing takeovers would limit the effect of Community law in this area to a bid for the securities of companies listed on a member state's stock exchange. A previous version of this Directive covered all public limited companies, listed or unlisted. At the same time, the amended Takeover Directive substantially restricts the defences that a target company could use. Under the proposed rules, the target could not in most cases issue voting securities, significantly increase or decrease its assets or liabilities, or re-acquire its own shares, for a time period that can last several months. Concern that such rules are too arbitrary and could prevent a target company from carrying out valid business activities will likely prevent for some time agreement on adoption of the Thirteenth Directive.

The proposed Directive also provides that a takeover occurs whenever a person or entity offers to acquire securities that would give the offeror at least one-third of the target's voting shares. In such a case, the offeror must make a bid to acquire all of the target's securities; partial bids are prohibited. The requirement to make a compulsory bid for 100 per cent of the target's securities could result in a high acquisition cost for the offeror, if all such securities are in fact tendered. Under Canadian federal rules, in contrast, an offeror can bid for only part of the target's outstanding securities. If all of the target's shares are tendered, the offeror can buy only the desired quantity on a pro-rata basis.

In the absence of harmonized EC rules governing takeovers, the national laws of member states continue to apply. The reason considerable controversy exists over appropriate EC policies in this area is that takeover rules in member states tend to differ widely.

In the U.K., the situation is similar to that of Canada and the U.S. While corporate directors have the freedom to resist hostile takeovers using various defences, including asset sales and the spending of cash reserves, the fact that many companies are widely held and the absence of any special takeover-defence mechanisms, such as those available in Holland, for example, have produced an active takeover climate.

Likewise, both the French commercial community and government have in recent years adopted a more positive view of takeovers; indeed, various administrative obstacles to share bids have been relaxed. For example, new rules that will come into force in mid-1991 limit the right of companies to defend against takeovers by issuing shares to a related company in exchange for shares of the latter. The privatization of several major enterprises and the fact that many French companies are no longer as closely held as they used to be have also made it easier for investors to acquire effective control of French companies.

In contrast, it is extremely difficult to arrange a hostile takeover in either the Netherlands or Germany. Under Dutch law, a company is not considered merely an extension of its shareholders. Rather, directors must act in the company's broader interests, which are considered to include the positions of its employees, creditors and possibly customers. Management has the authority to reject a bid, even when a majority of shareholders favour it.

Apart from a conservative strain that runs through much of the German business community, another major obstacle to hostile takeovers in Germany is the fact that German companies tend to be very closely held. Of some 600 companies listed on German stock exchanges at the end of 1989, in fewer than 10 per cent did the general public hold at least half the shares. For the most part, control rests with individuals, family groups or German banks, the latter of which do not have the same limitations on corporate investment as do their Canadian counterparts.

9. Competition Legislation

The Community has harmonized its laws regarding competition in two basic ways. First, rules to prevent anti-competitive business practices apply to all enterprises carrying on trans-border business in the EC. While national laws govern restrictive practices within any member state, the EC rules create a standard that applies to trade between member states.

Although Community law in this area differs from provisions of Canada's Competition Act with regard to some types of prohibited behaviour and the way such behaviour is treated, significant similarities exist as to the kinds of commercial conduct that the respective systems try to prevent. Specifically, anti-competitive behaviour under the EC code includes collusion to fix prices, control production or investment, or divide a market, where such activities negatively affect trade between member states. Likewise, enterprises that control a substantial share of any market cannot use their dominant position to impose unfair prices or other conditions on inter-country trade. Exemptions may apply if a prohibited practice is shown to improve production conditions or economic progress generally and does not substantially limit competition.

EC provisions in this area are often less detailed than those of Canadian legislation, which prohibits a variety of other illegal activities, including conspiracy, misleading advertising and various marketing techniques, such as pyramid selling. On the other hand, EC and national courts have been active over several years in investigating and charging alleged offenders against the Community's competition law, which they have often applied broadly. Canadian companies doing business in the EC should satisfy themselves that any major agreements they may enter into conform to its terms. The European Commission has judicial powers in this field, enforced through the European Court of Justice. However, the national courts may also enforce EC competition law, which provides for fines against offenders and the voiding of illegal contracts.

Second, an EC regulation implemented in September 1990 governs cross-border mergers with a so-called Community dimension. This Merger Control Regulation is intended to prevent large companies from concentrating economic power and reducing competition by merging with each other. A more detailed explanation of how the merger Regulation operates is contained in the *EC 1992 Interdepartmental Working Group Report on Competition Policy* (EAITC, 1991).

Under the Regulation, a merger with a Community dimension is defined to mean any merger in which the global, consolidated gross revenue of the merging enterprises amounts to -- in the case of industrial or non-financial services companies -- at least 5 billion ECUs and in which at least two of the merging enterprises earn over 250 million ECUs, unless at least two-thirds of the gross revenue of each merging enterprise is earned in one member state. The high thresholds that must be reached before the Regulation applies means that in most cases it would affect only the biggest of Canadian subsidiaries in the EC. A smaller company could, however, be affected, if it is part of a merger involving several larger entities.

In reviewing any merger that meets the Regulation's criteria, the European Commission will mainly consider whether or not the proposed merger restricts competition. This is based on several factors, including the economic impact on suppliers and consumers and the creation of barriers in the particular industry sectors involved.

At the same time, the Regulation allows the Commission to consider several factors that could allow merging companies to justify a proposed corporate consolidation. These factors include a situation in which a business union improves the competitive structure of Community business. A similar defence is included in Canada's Competition Act, which allows merging companies to take into account the extent of foreign competition -- thus recognizing that concentration of domestic production is not necessarily harmful, if the market has access to imported, competing products.

Since the cross-border merger Regulation is so recent, it is impossible to get a sense of how the European Commission will treat individual cases. A reasonable probability at this time is that the Commission will tend to be lenient in restricting mergers, recognizing that many Community companies need to grow in size and scale if they are to compete effectively for global market share against bigger players from the U.S. and Japan.

Companies proposing a merger that falls within the criteria set out by the Regulation must notify the European Commission within one week after either signing an agreement or launching a tender offer, whichever comes first. If the Commission wants to investigate the merger, it must announce its decision to do so within one month of the notice date. It then has up to four more months to carry out the investigation and announce its decision.

Rules governing corporate concentration as a result of mergers involving business activity that mainly takes place in a single member state are dealt with under the national law of individual EC countries.

10. Shareholder Rights and Remedies

Except in relation to the Community-wide rules described in this report, the rights and remedies of shareholders are dealt with under the national laws of EC member states. Accordingly, substantial local differences continue to exist in this area. Under Dutch law, for example, shareholder rights are restricted in favour of allowing management considerable latitude in carrying on the company's business. In the U.K., the directors of widely held companies have considerable authority, thanks to rules deeming that unreturned proxies support the board's position on any resolution. In contrast, Canadian corporate legislation has recognized and given to shareholders considerable rights that limit management discretion.

11. Winding-up and Liquidation

The Community has not yet introduced common rules to deal with the winding-up and liquidation of companies. These are still governed by the national law of the member state in which the company is registered.

12. Dispute Settlement

As a general rule, EC rules prevail over national laws of member states in cases where differences arise. In practice, the kinds of litigation issues that can occur when businesses consider that their rights have been infringed are often complex and cannot be fully dealt with in this report.

By way of summary, it should be noted that EC law gives individuals and businesses the right in such cases to bring an action before the European Court of Justice if they have a so-called sufficient interest. Whereas in Canada the courts have broadened the scope of the right, the European Court has interpreted this right very narrowly. The effective result is that companies will dispute virtually every such legal action before a national court. Such actions can arise in cases where, for example, an alleged infringement of intellectual property has occurred or where an employee considers that he or she has been unfairly treated. This could happen because a member state's implementation of a Directive is inconsistent or because a Regulation is improperly applied by an administrative body.

In a case involving only domestic law, an action will proceed in the normal way under the national courts. In a case involving alleged non-conformity by national law to Community rules, a person or company that considers that it has been prejudiced against will typically bring an action in the national court of the relevant member state. In complex cases, the national court will sometimes make a reference to the European Court. Where the problem is cross-border, the EC's Convention on Enforcement of Judgments will apply to determine where the dispute should be heard.

An alternative approach in a case of alleged non-conformity is to bring a complaint to the European Commission. In such a case, however, the complainant loses control over the proceedings (and any possibility of winning damages), since the Commission effectively takes over the proceedings.

III. EUROPEAN ECONOMIC INTEREST GROUPING

One way in which a Canadian business can carry out a variety of business functions throughout the EC, using a single vehicle to do so, is through a mechanism called the European Economic Interest Grouping. A Grouping may be an especially attractive structure for Canadian companies considering joint operations with other enterprises doing business in the Community, as it offers all the advantages of such a vehicle and fewer liabilities. At the same time, a Grouping will be available only to Canadian investors who already have an EC operation. This is because Groupings can be established only among companies or firms already registered in the Community.

Wanting to provide greater cohesion than allowed under existing corporate rules, but recognizing that member states are still not ready to adopt a comprehensive set of Community-wide company laws, the EC instead adopted a Regulation, which came into force in July 1989, that created the Grouping as a compromise solution. Between that date and the end of 1990, some 120 Groupings were formed.

A Grouping is a business organization, set up by two or more founders in different member states, with all the attributes of legal personality (the power to acquire assets and liabilities and to sue and be sued) but whose founders retain liability for the Grouping's obligations, including taxes. A key attraction of a Grouping is that it can be registered the same way in each Community country that has approved the format. Italy, Spain, Greece, Portugal and Luxembourg are still finalizing arrangements to allow Groupings to be registered locally. The Grouping is essentially governed by a uniform set of EC rules, including formation and wind-up procedures, and there are no requirements for minimum capitalization.

In many ways, a Grouping resembles both joint ventures and partnerships, but with several advantages over each. Unlike a joint venture, a Grouping has independent legal status, which tends to convey the idea of permanence. While a partnership may also have permanence, the existence of Community-wide rules make it easier for participants to administer a Grouping than either a partnership or a joint venture. National laws will apply only to Groupings in areas specifically designated by the Grouping Regulation (for example, whether or not a contract is valid) or in cases where the Regulation is silent (for example, on insolvency and liquidation issues).

At the same time, restrictions are placed on what a Grouping can do. In order to obtain approval from EC member states on the right to create Groupings, it was agreed that a Grouping could not be a profit centre for participants. Rather, the purpose of the Grouping is to improve or facilitate the profit-making activities of the entities that it comprises. For this reason, a Grouping cannot have more than 500 employees -- the notion being that employment and profits will remain concentrated in the participating companies. At the same time, there is nothing in the Regulation that specifically prevents a Grouping from being profitable. A Grouping has no power to control the activities of its members, nor can it hold shares in any of them.

Within these limitations, the Grouping structure allows participating companies to carry out a variety of operations, which may help them achieve commercial goals. For example, several companies can form a Grouping for the purpose of carrying out research and development operations. The results of this research can then be commercially exploited by the founding companies. A Grouping could also be used to set up a common marketing or purchasing operation for participants.

A Canadian company can participate in a Grouping in two ways. If it has operations in more than one EC member country, two or more of these operations can be the founders of a Grouping. Alternatively, a Canadian company with a presence in only one EC country can become part of a Grouping, together with one or more unrelated businesses located in other member states.

The basis of a Grouping is a contract among its members, who can be either businesses or individuals. Business participants in a Grouping must, however, be registered in EC countries, meaning that they must be companies or partnerships; a branch is not an acceptable member of a Grouping.

A Grouping must have at least two members. In the more common case of a Grouping that consists of corporate participants, at least two participants must have their head offices in different member states. If individuals are involved, they must carry on their main business activities in different member states.

The Regulation provides that a Grouping is created by a formation contract, which sets out the rights and obligations of the various participants. As with a typical joint venture agreement, a formation contract will specify how profits are to be distributed and how long the arrangement will last -- although it can have indefinite duration, just as a corporation does. The contract must also include the name chosen for the Grouping, which must be preceded or followed by the words "European Economic Interest Grouping" or the abbreviation EEIG.

The contract must include the address of the Grouping's central office and a description of its business purpose, together with basic information about the name and location of each participant. In some cases, a member state may require that additional information be provided as part of the registration process. The formation contract must be filed in a designated registration office of the member state in which the Grouping will be headquartered, as must any subsequent amendments to the contract or changes to the basic information it includes. A copy of the contract must be published in the official gazette of the member state.

A Grouping must have an official office in the Community. This can be located either where the Grouping has its own administrative operations or where a participant has an administrative office. However, a Grouping address can be changed either within the same member state or to another country.

Typically, a Grouping is managed by one or more persons, who are appointed either in the formation contract or by a decision of the participants, who retain ultimate control of the Grouping. Each participant can vote on important decisions to be made by the Grouping. The formation contract may give more than one vote to any participant, but, to protect minority interests, no single participant can have an outright majority of votes, and unanimity is needed for certain fundamental changes, including those in the Grouping's objectives, voting structure or membership.

With regard to liability, including tax, the Grouping passes all obligations on to its members. Each participant will be responsible for its share of taxes, in the participant's country of residence, in proportion to the income allocated to it by the Grouping agreement. Participants should be careful to obtain appropriate guarantees or insurance from each other in relation to non-tax obligations, since, just as in a partnership, each member is liable for all debts of the Grouping as a whole.

IV. THE EUROPEAN COMPANY

In order to create a fully harmonized system of company law, the Community needs to allow the creation of a European Company, governed by its own set of rules, independent of the national laws of any member state. In such an arrangement, the relationship between European business law and the company legislation of each member state would be similar to the relationship that exists in Canada, where investors can choose between incorporating under the Canada Business Corporations Act or the company law of any individual province.

The most recent version of a proposed European Company Statute was put forward by the European Commission in 1989. The current proposal is more attractive to most member states than is the Fifth Council Directive, discussed in Section II-6 of this report. Unlike the Fifth Directive, which would impose compulsory rules on all EC countries, the European Company Statute would be voluntary; it would govern all companies incorporated under it, but not prevent an investor from incorporating under the law of any member state, as modified by existing Community rules. In addition, member states could have a degree of flexibility in implementing rules governing the sensitive issue of employee participation in any European Company.

Various member states still cannot agree on this issue or the question of how the administrative mechanism of the European Company should be structured. The extent of disagreement suggests that the Statute, together with its accompanying Directive governing employee participation in the proposed European Company, is still far from being approved. A summary of the provisions contained in both documents is, however, relevant for prospective Canadian investors, as these provisions indicate the probable direction in which the EC is moving in the area of business regulation.

The Statute would let public or private companies create a European Company, as long as at least two of the founding companies are resident in different member states. In this regard, the Statute reflects the desire of member states to retain sovereignty, where a business operation has no cross-border dimension. In Canada, in contrast, investors can incorporate a company under the Canada Business Corporations Act, regardless of whether or not they actually carry on business in different provinces.

The minimum capital requirement for the proposed European Company is 100 000 ECUs, of which 25 per cent must be paid up at the time of formation. The company's registered office must be in the member state in which the company exercises real management and control. This requirement ensures that a set of national rules will apply, in cases either where the proposed Company Statute specifically incorporates national law or where an issue arises that is not specifically addressed by the Company Statute. A European Company could change the location of its registered office by obtaining shareholder approval to amend its corporate constitution.

The Statute also contains rules to govern company disclosure requirements, formation and the issuing and redemption of securities. Most of these are already familiar to Community businesses, being derived mainly from existing Directives.

Difficulties arise from the proposed Statute's rule requiring companies to choose either a two-tier administrative board or a unitary system. These approaches to management structures, similar to those contained in the draft Fifth Council Directive, are described in Section II-6 of this report. As in the case of the Fifth Directive, disagreement persists on the adoption of such a rule.

The other main area of contention concerns employee involvement in company decision-making. Although member states and, in some cases, individual companies could choose the type of involvement they prefer, the rules contained in a draft Directive that complements the Statute would require a European Company (regardless of size) to provide for some kind of employee participation in corporate decision-making. Such participation could vary from outright board membership to a requirement that management regularly inform and consult with employees on the company's progress and on any proposals that would significantly change the nature of the company's business.

These changes include plant closures, major asset sales or acquisitions and substantial corporate reorganizations.

The issue of management-employee relations in the Community is dealt with in greater detail in Section VI of this report.

V. TAXATION

Movement toward tax harmonization in the Community has proceeded slowly, mainly because unanimity is required to establish rules that limit any member state's sovereignty over fiscal policy. Nevertheless, the Community has recently adopted several important measures that simplify tax considerations for Canadian and other investors in the Community and decrease overall tax burdens.

1. Withholding on Dividends

Under recently adopted rules, EC countries have agreed substantially to eliminate any withholding applied to the payment of dividends by a subsidiary in one member state to a parent in another, where the latter holds at least 25 per cent of the subsidiary's voting shares. Individual countries can lower this percentage.

This change will reduce the extent to which Canadian and other investors in the Community make investment decisions for tax reasons rather than for commercial reasons. It will also make it more attractive for a company incorporated in a Community country to establish a subsidiary in another member state, rather than simply setting up a branch. This relief from withholding applies to both private and public limited companies.

Under bilateral tax treaties among EC member states, many dividends already pass tax free from one country to another. However, different rates of withholding apply in other cases, thereby increasing or decreasing the cost of operating a subsidiary in some jurisdictions. As a result, a branch operation has often been a more attractive way for a company to do business in another EC country, for several reasons.

Some EC countries prohibit their companies from carrying forward any credit for withholding paid by subsidiaries in other member states. In such a case, a parent that earns less taxable revenue in any year than the amount withheld on its subsidiary's remitted dividends would lose the difference. Even in cases where a credit is available, the lengthy delays involved -- sometimes years -- before it is actually paid can create cash-flow problems. In contrast, no member state withholds amounts on profits that a branch remits outside the country. As a result, these problems are avoided.

Under the new rules, a member state retains the right to impose a tax on distributed dividends, which is considered to reflect local benefits conferred on the parent company by the existence of the subsidiary. This amount cannot, however, be more than 5 per cent of the dividends paid by the subsidiary.

The new withholding rule substantially levels the playing field as between subsidiaries and branches, where inter-country payments are concerned. The rules must be implemented in all member states by the beginning of 1992, with special transition provisions for Germany, Greece and Portugal.

A Canadian company with a Community subsidiary still faces the question of receiving dividends in Canada. The new rules do not change the treatment of withholding on amounts paid to recipients outside the EC, which continue to be governed by the national law of the country in which the subsidiary is incorporated. As modified by bilateral treaties between Canada and each Community country,[2] the withholding rate is either 10 or 15 per cent, with the exception of Luxembourg, where it is 5 per cent. Cash-flow considerations can make it attractive for a Canadian company to incorporate an EC subsidiary in a jurisdiction with a low rate of withholding on dividends paid to Canada. A company must, however, have at least a minimum level of business activity in such a jurisdiction, or else such a subsidiary could be disregarded, on the grounds that it exists only for purposes of tax avoidance.

A proposed measure to eliminate withholding on interest and royalty payments will likely be adopted in the near future, thereby further simplifying inter-corporate payments within the Community. The governments of states that tend to be technology importers -- notably Greece and Portugal -- have been concerned that such action in relation to royalty fees will result in a substantial loss of tax revenues; however, this issue should be resolved by allowing these countries a long transition period before they are subject to the new rules.

2. Direct Taxation

Basic corporate tax rules applicable to Canadian-controlled and other investments in the Community are governed exclusively by the laws of individual member states. Accordingly, in some cases, it can be important for a prospective investor in the EC to determine which country produces the most favourable after-tax result, on the basis of local tax measures coupled with the impact of that country's treatment of dividends and interest and royalty payments remitted by the European operation to the Canadian parent.

At the same time, a useful harmonizing measure was adopted by the Community in 1990 and is due to be implemented in member states by the beginning of 1992. This change allows private and public companies anywhere in the EC to defer the payment of capital gains tax, arising from a trans-border merger of two or more companies or a split of a single company into two or more parts. This changes existing rules, under which tax may or may not be payable, depending on the country in which the assets in question are located.

Under the new rule, a Canadian-controlled or other company resident in an EC member state would not be subject to capital gains liability when it disposes of any assets acquired through a merger with a company registered in another Community country or acquired as a result of a cross-border division into two or more companies. At the same time, the company acquiring the assets in question would have to inherit both the original cost base and the accumulated depreciation relating to the assets, so that any tax payable on an eventual disposition of the assets would be unchanged.

3. Indirect Taxation

To allow goods to move freely among EC member states, it is necessary to eliminate border formalities and duplicate tax administrations, which cost Community producers an estimated 15 billion ECUs per year. Although no customs duties are collected in a common market, border posts are still necessary, so that each member state can collect value-added tax (VAT) on the supply of goods and services.

Since the late 1970s, the Community has had a common VAT base, which defines those transactions that are subject to VAT, determines when VAT obligations arise and establishes a mechanism for obtaining VAT credit when taxed goods or services are in turn supplied to another taxpayer. The existence of a common base means that Canadian or other businesses with operations in more than one EC country will face essentially the same arrangements in each country.

VAT rates still differ substantially among Community countries. In order for exported goods and services of all member states to be competitive, each country refunds any VAT it has charged on such services and products. But this arrangement means that a Canadian or other operation engaging in cross-border trade within the EC must spend time and money on the procedures involved in getting VAT refunds and in having the particular goods or services re-taxed when they are imported into another country.

A proposed two-part solution to this problem would end the refund mechanism and allow taxpayers who buy goods and services in any member state to pay VAT in that state. If this happened today, purchasing would swing heavily in favour of countries with low tax rates. Accordingly, the Community's second goal is to harmonize VAT rates substantially by the end of 1996.

Switching to a system in which VAT is collected in the seller's country instead of the buyer's means that countries that are net importers of goods and services will lose tax revenues, compared with the present situation. To deal with this concern, the Community has proposed a clearing system, which would restore revenue losses to states that have trade imbalances.

Progress toward VAT harmonization is proceeding slowly. Many member states are resisting rate harmonization, which represents a further erosion of their fiscal sovereignty. In addition, countries that are net importers simply do not trust tax authorities in other states to operate the proposed clearing mechanism in a way that will compensate them fully for VAT losses. Nevertheless, it is likely that VAT harmonization will occur in the decade of the 1990s, substantially increasing economic efficiency in the Community.

VI. MANAGEMENT-EMPLOYEE RELATIONS

An important consideration for Canadian managers considering the establishment of a Community operation is the kind of relationship they can expect to have with their employees. National rules in many EC member states create employee rights and powers that are considerably greater than those with which Canadian managers are familiar. But this is not true of every Community country.

While the Community is working to articulate a common labour-management policy, presumably along lines that increase employee authority in several countries, no consensus yet exists on doing so. As discussed in Section II-6 of this report, a major cause of the Community's failure to adopt the Fifth Council Directive, dealing with the harmonization of administrative structures in public limited companies, is disagreement on employee participation in the administrative process. The same issue is a major reason for delay in adopting legislation to establish a European Company, discussed in Section IV of this report.

Considerable national differences will almost certainly continue to exist, even if Community-wide rules are passed, since proposed laws in this area are being designed to allow considerable flexibility in the way companies can deal with employee participation. An extreme example of this broad-brush approach is found in the so-called Social Charter on employee rights, presented by the European Commission in 1989. All member states except the U.K. approved the Charter, which identifies 12 basic employee rights, including the right to improved living conditions, vocational training and adequate social security. But most of the proposals are so broadly worded that the Charter is more a set of moral guideposts than a potentially enforceable code of conduct for employers or governments.

Prospective Canadian investors in the EC should, accordingly, concentrate on understanding and fulfilling their obligations under existing Community rules in the area of employee rights and powers. Changes will occur in this area of EC rules, in the same way they may occur in Canada, but evolution will be gradual, not radical. As well, it is important to review the different rules and obligations applicable in individual countries, since these differ widely.

In this regard, Canadian investors should be aware of the need to have a so-called works council under the national laws of most member states. These councils are made up of employee representatives, who are entitled to information from and consultation with management. Even in relation to this existing requirement, however, considerable local variation exists. The U.K. and Ireland do not require any company to have a works council. The minimum size of any company required to have a works council varies from state to state. In France and Spain, for example, this number is 50; in Germany it is five.

Each EC country also has different rules as to the kind of information and consultation that an enterprise must provide. A Belgian company, for example, must provide information at different times (quarterly, annually and every four years, depending on the specific type of information involved) to a works council, which has no negotiating authority. In Germany, a works council has rights to receive information and be consulted on all significant issues affecting company operations; it also has the right to negotiate on specific issues, including remuneration methods and organization of work time.

At the Community level, various rules govern employee rights. These include equal treatment for men and women with respect to pay and other working conditions and employer obligations in the event of insolvency or collective layoffs. A variety of health and safety regulations have also been adopted by the Community, too numerous to review in this report. In no case will the type of business activity mandated by these rules be vastly different from the experience of Canadian companies under domestic legislation.

As with national laws of EC member states, important differences exist in the way Community laws in this area are implemented and enforced. In relation to equal treatment, EC rules require member states to pass national laws that cover pay (widely defined to include fringe benefits, bonuses and non-cash benefits such as company cars), working conditions and access to employment, training and promotion. Employees must also be able to bring discrimination actions in the national courts, which generally have the power to impose fines and to force employers to change discriminatory practices.

In practice, these rights are not always fully available. In several countries, for example, most workers are union members, whose employment conditions are substantially established through collective agreements. The national courts of these countries may be reluctant to find, for example, that female employees governed by such agreements have been treated unequally, on the theory that the union would not have negotiated terms that discriminate against women.

With regard to insolvency, EC rules require member states to establish a guarantee fund, which helps safeguard employee wages. In the U.K., this protection comes from employer contributions to an insolvency fund. In France, employers must take out insolvency insurance to protect debts due to employees, while both France and the Netherlands give workers the additional protection of being "super-privileged" creditors of insolvent employers, taking precedence over all other claimants, including the tax authorities.

In the case of collective layoffs, all member states except Italy have passed laws requiring companies to notify employee representatives in advance of any collective layoff, as such redundancies are defined by each country.

VII. CONCLUSIONS

Several critical factors will make the EC a major focus for overseas business by Canadian companies in the early 1990s. A likelihood of strong economic growth, relative to other regions of the world economy, will mean opportunities to build markets. In part, the gradual displacement of many national laws by an increasingly large body of Community-wide rules will stimulate that growth by reducing distortions in investment and trade decisions. In most cases, the harmonization of EC laws offers to investors whose base of operations is located outside the Community the same advantages it offers to EC residents.

For Canadian companies, an important area of harmonization involves company law and related rules. In many cases, these new systems impose obligations that companies must recognize before investing. At the same time, the current framework -- a mix of national and Community laws, together with a hybrid of EC rules that allow a degree of national modification -- means that Canadian investors must also be aware of continuing regional differences. They can use these continuing differences to pick investment destinations that are more attractive from an administrative viewpoint. They should also realize that their competitors may be able to exploit regional differences to their own advantage.

From the viewpoint of company and related laws, a Canadian company considering an EC investment should:

- determine how best to protect intellectual property;
- determine what type of business organization to establish, in light of an EC goal to treat similar operations alike, regardless of form;
- determine how to benefit from new structures, such as the European Economic Interest Grouping;
- be prepared for a higher degree of disclosure requirements;
- be prepared for greater restrictions on share issues and redemptions;
- be prepared for additional due-diligence operations related to proposed mergers of public companies;
- recognize that substantial differences in national tax rules continue to be important for investment decisions;
- investigate labour-management rules applicable to different countries, to ensure the existence of a system of relationships that will be comfortable for both sides;
- track EC proposals for new developments in company and related law, which will have an impact on business operations; and
- obtain the assistance of qualified, local professional advisers.

APPENDICES

The following materials are intended to supplement the information contained in the main text of this report. They are divided into three parts.

In Appendix A, two case histories offer evidence of successful entry into the EC market by medium-sized Canadian companies. They also reflect company recognition of differences in the way business is conducted in each country -- for example, the way in which disclosure rules, employee benefits and tax considerations affect managerial decision-making.

In Appendix B, a series of charts reflects several macro-economic factors relevant to investors, including the extent to which both Canadian investment in and trade with the EC have increased in recent years.

Appendix C lists company law Directives and Regulations adopted and proposed.

Appendix A

CASE HISTORIES

Canadian direct investment in the Community has grown steadily during the past decade, from a stock of about C$5 billion in 1983 to C$17.8 billion in 1990. Approximately two-thirds of this inflow has gone to the U.K. About two-thirds of Canadian direct investment in the EC has been in the manufacturing sector.

A good deal of Canadian investment activity in the Community has been made by large companies, but the following examples show how small and medium-sized enterprises have built successful operations in the EC.

Company One

This technology-driven, Ontario-based company has over 500 patents for parts and equipment used in the plastic injection industry. A family-owned business, it has annual revenues of about C$25 million, from sales in North America and 25 other countries. After exporting to Europe for 14 years, mainly to Germany, it decided to establish an EC operation.

The company had several reasons for doing so. It saw Germany in particular and Europe in general as strong markets, on which it had to focus a major effort. To expand its sales in Europe, the company believed that only a substantial physical presence would convince customers that it had a commitment to them.

The company was also concerned that, as its products and processes matured, its technological lead over European competitors would shrink. Unable to rely on a unique market niche, it would be vital for the company to offer its customers improved service -- immediate response, customized product and facilities in which to demonstrate its products and services. Finally, the company feared potential protectionism, which might have obstructed Canadian personnel travelling in and out of Europe in connection with company business.

To solve these existing and potential problems, in 1989 the company built its own greenfield plant in Germany and incorporated a private limited company, 100 per cent controlled and managed by the Canadian owners. As of the end of 1990, the European operation had revenues of about C$30 million. The German plant sells locally, as well as to the U.K., France, Italy and Austria. The company expects the European operation to provide it with a convenient springboard, from which to penetrate emerging markets in Central Europe and the U.S.S.R.

Although the German company is doing well, Canadian management would do several things differently, especially in the area of employee relations, if it were to open a second plant. High costs associated with terminating employees and paying for social programs in Germany make it imperative to have a hiring policy that can find the right employee virtually every time and a training program that ensures that employee productivity rises quickly to optimal levels.

Another concern the company has about doing business in Germany is the extent to which it must disclose information to the public about its operations, since it considers this to be a way in which competitors can learn about its business strategies. But this is not something the company can control. Given the attractive results it is experiencing in the European market, the company is willing to accept some conditions it dislikes.

Company Two

An Ontario-based producer of specialty food ingredients, the company has revenues of some C$23 million in Canada. Having captured some two-thirds of the Canadian market in its sector, it is looking to expand its operations elsewhere. For this purpose, it has acquired a U.S. plant, and in 1989, it relocated a U.K. operation from the London area to expanded premises in Wales. The latter operation currently has revenues of about C$9 million, mainly in the U.K. It also sells through commission agents in France, Germany and the Netherlands.

The company believes that Europe -- in particular the EC -- offers considerable growth opportunity and is considering the establishment of a more substantial presence in several countries. Such an arrangement could help improve its image in new markets and also provide some scope for tax planning, by choosing a jurisdiction in which to locate a management office that would flow funds back to Canada.

The U.K. operation employs 60 persons, including a Canadian managing director, who lives in the U.K. and has an employment authorization. A private limited company, the U.K. operation is a wholly owned subsidiary of the Canadian parent.

From its experience, the company has identified several factors it considers important in starting up a European operation. First is that local incentives can be extremely attractive and worth pursuing. In its recent expansion, the company benefited from a grant by the Welsh government, including an existing plant and equipment, valued at about C$1 million. To qualify, the company had to submit a detailed business plan and agree to make contributory investments and to hire at least a specified minimum number of employees. The company considers that the cost of these commitments plus additional transportation expenses associated with a less central location will be more than compensated for by the value of the incentive.

Second, the company notes that start-up financing for an EC operation can be a problem. Typically, a small or medium-sized Canadian business will not be known to an EC bank, which is accordingly unlikely to offer the most competitive terms or may not be willing to take on the business at all. A potentially valuable strategy in this regard would be to start negotiating early with local lenders and to have an attractive, comprehensive business plan to show them. Debt financing from Canadian sources is an option for investors whose domestic operations can support additional lending. A joint venture structure can be helpful in this regard, since the EC partner will have local presence and a track record. An investor who acquires plant and equipment may be able to get the seller to give back a loan on the assets, on favourable terms.

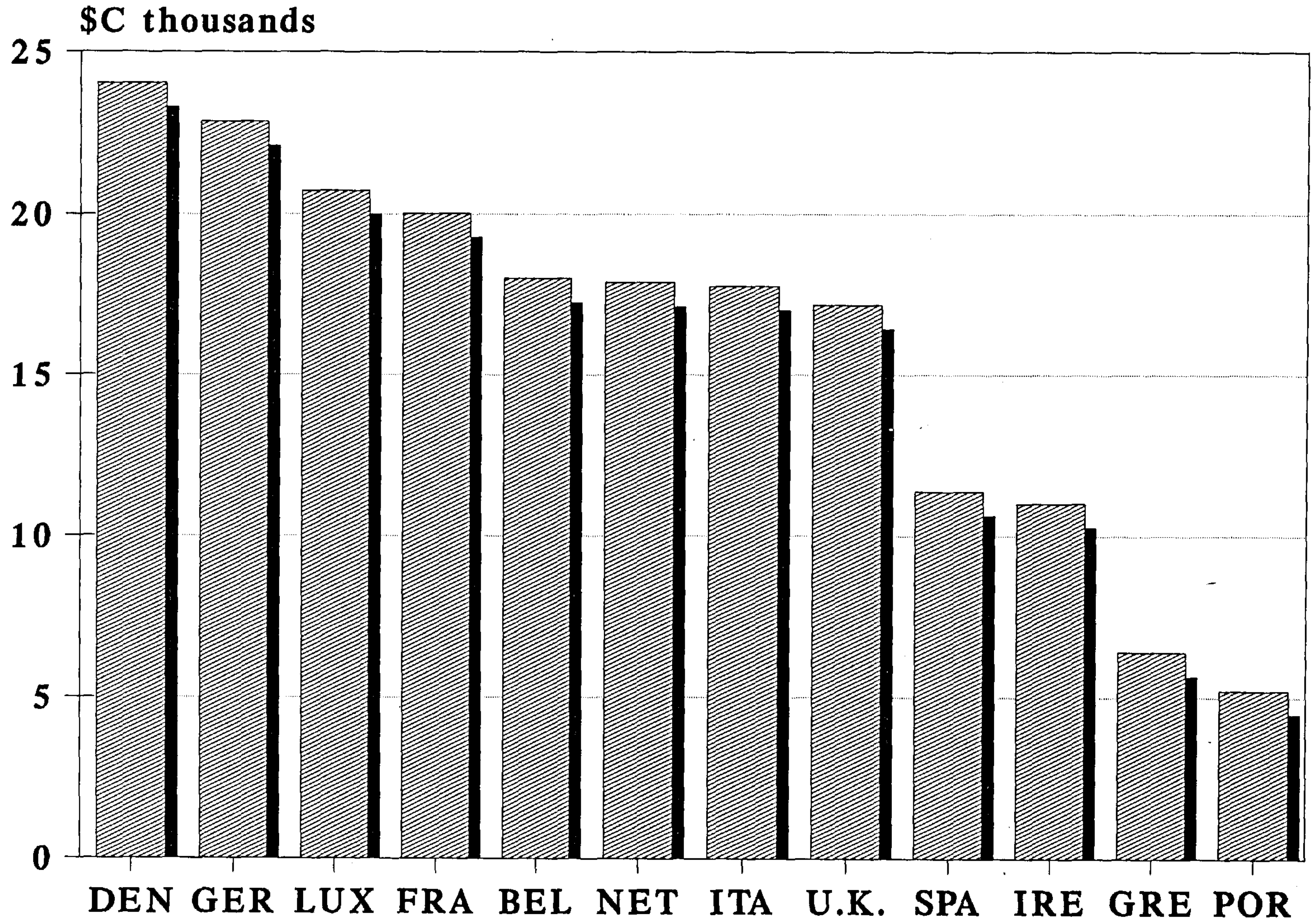
A company with European earnings must also decide how to manage its foreign exchange exposure. A Canadian company that borrows at home in Canadian dollars for its EC operation may have problems if it expects to repay the loan from amounts earned in a currency that is losing value against the dollar. One way of dealing with such a situation is to shift production to the EC subsidiary, thereby taking advantage of the lower exchange rate to boost sales volumes.

Appendix B

EC ECONOMIC AND TRADE FIGURES

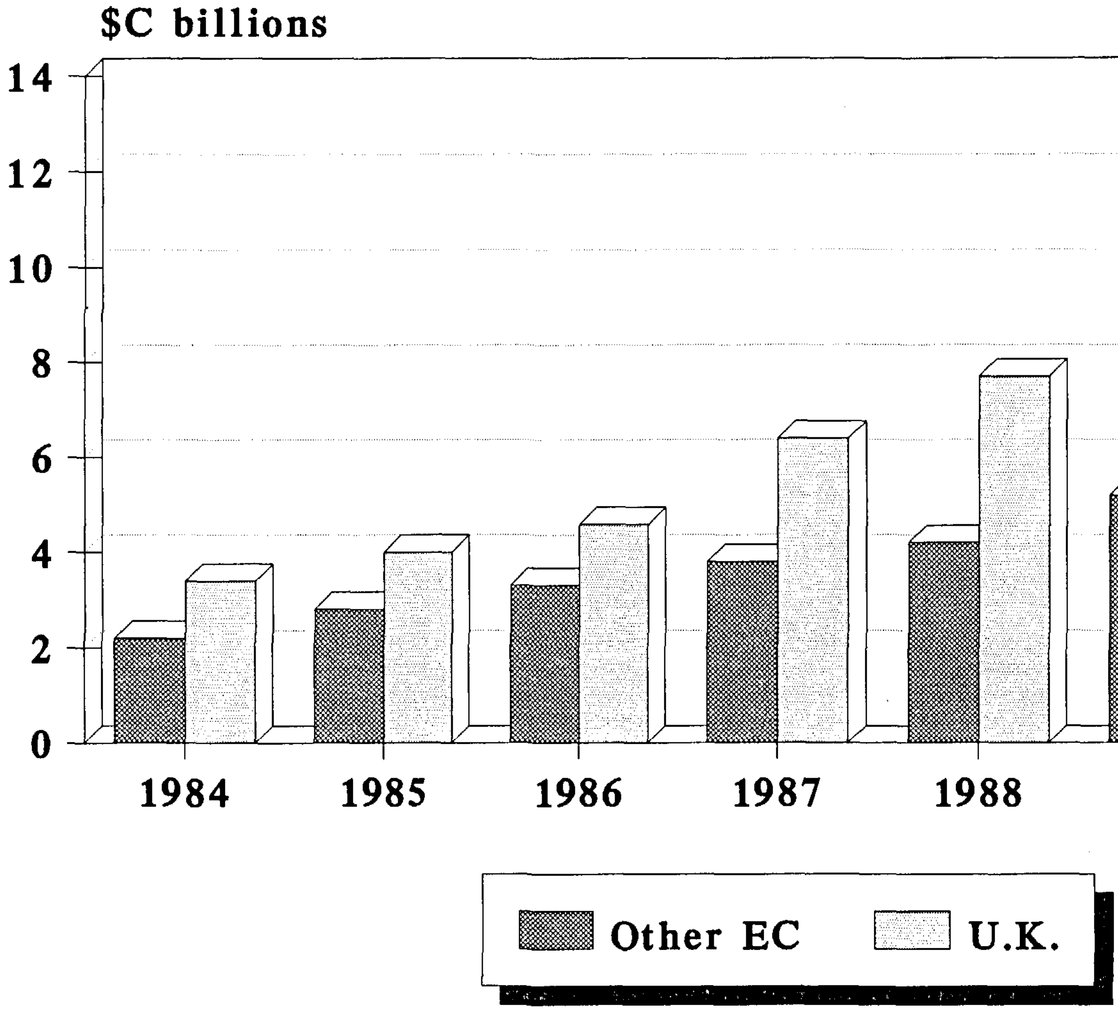
The following charts provide a measure of the strong recent history of investment and trade that Canada has with the EC. Some comparative figures are provided for the U.S. and Japan. The final table indicates the volume of trade that EC member states carry on among themselves, indicating that businesses that establish EC operations may benefit, insofar as they could benefit from possible preferences that other EC companies have for dealing with each other.

EC GDP/CAPITA, BY COUNTRY (1989)



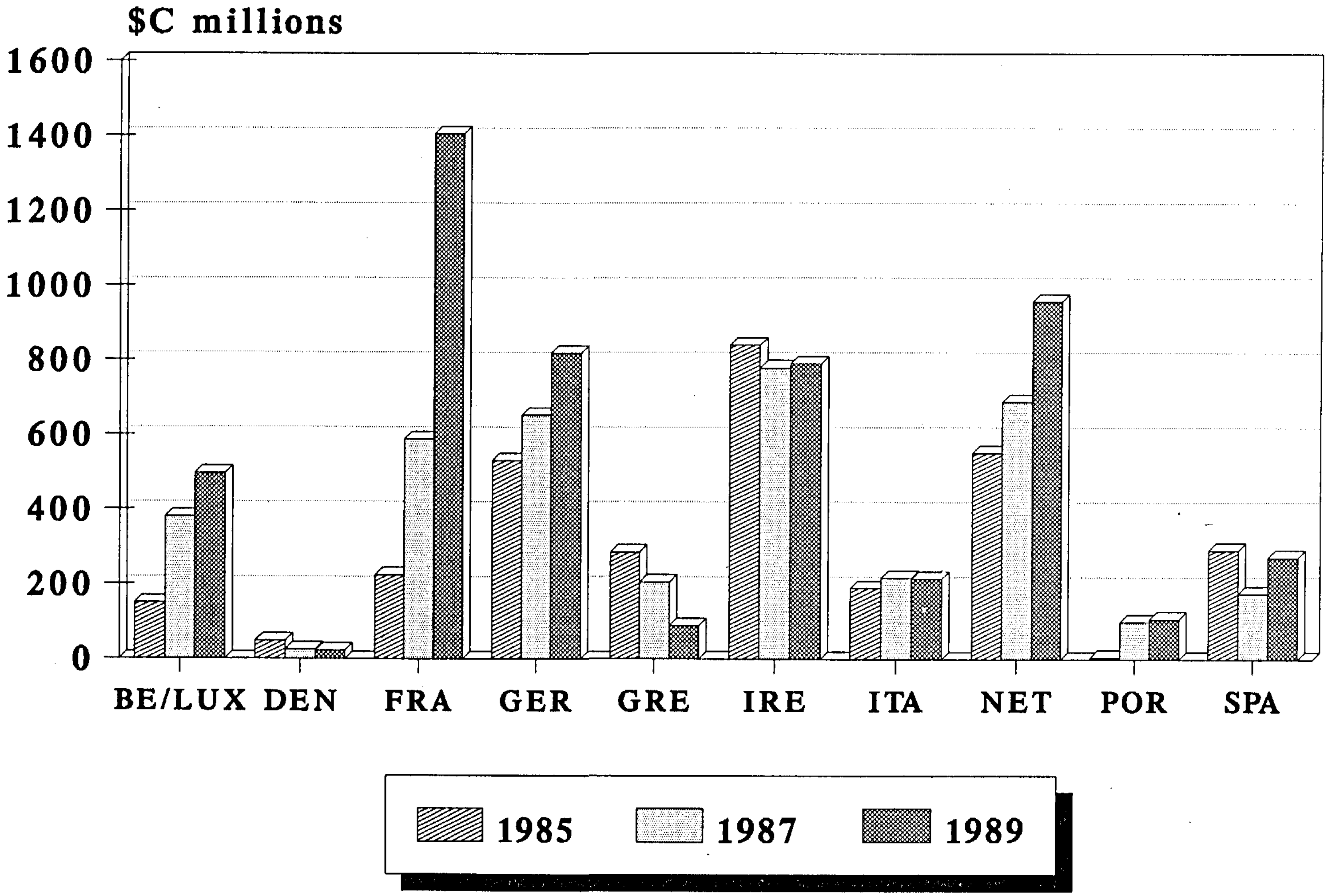
Source: OECD Main Economic Indicators

CANADIAN FOREIGN DIRECT INVESTMENT
IN THE EC (1984-1990)



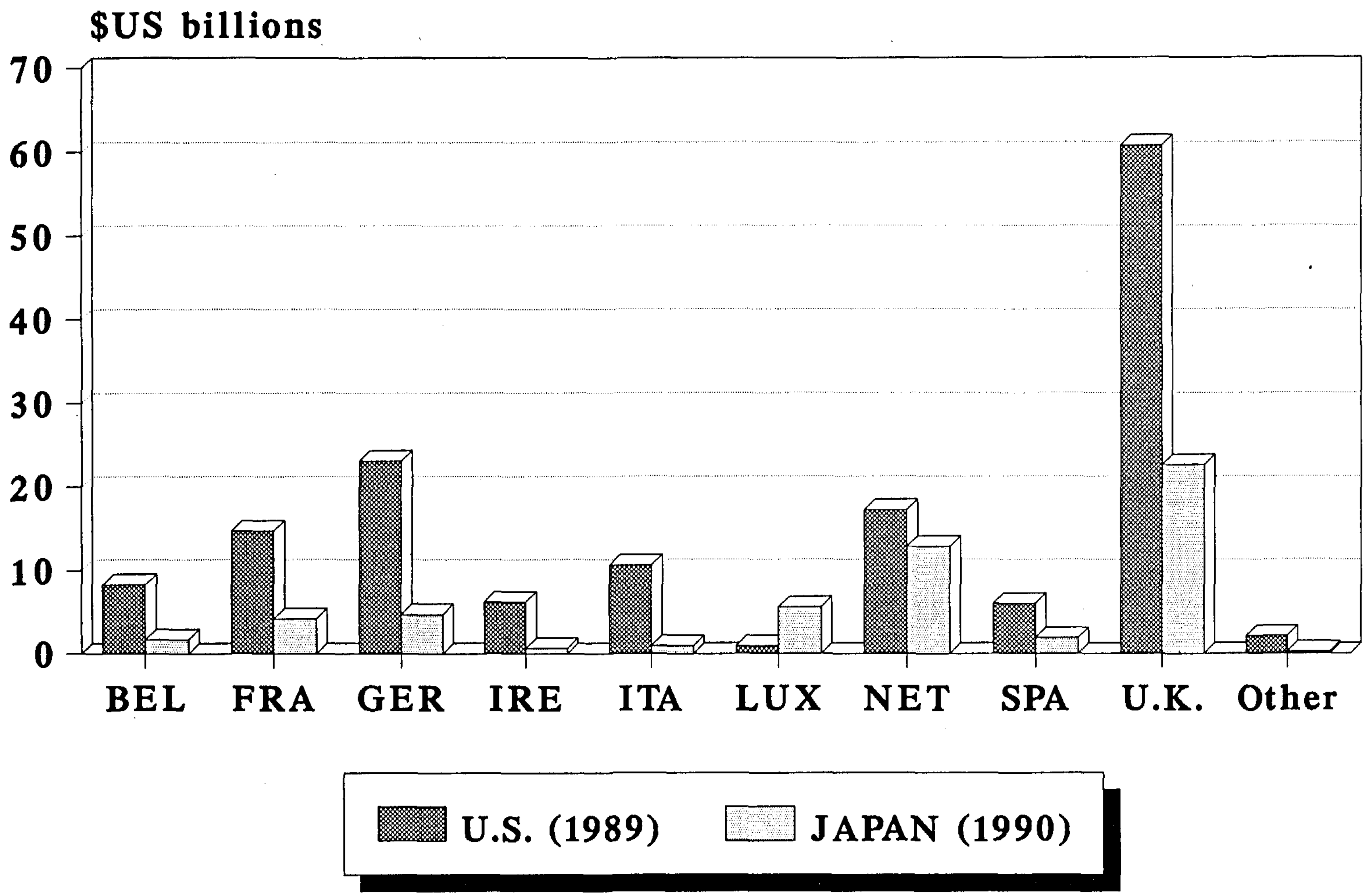
Source: Statistics Canada

CANADIAN FOREIGN DIRECT INVESTMENT IN NON-U.K. EC MEMBER STATES (1985-1989)



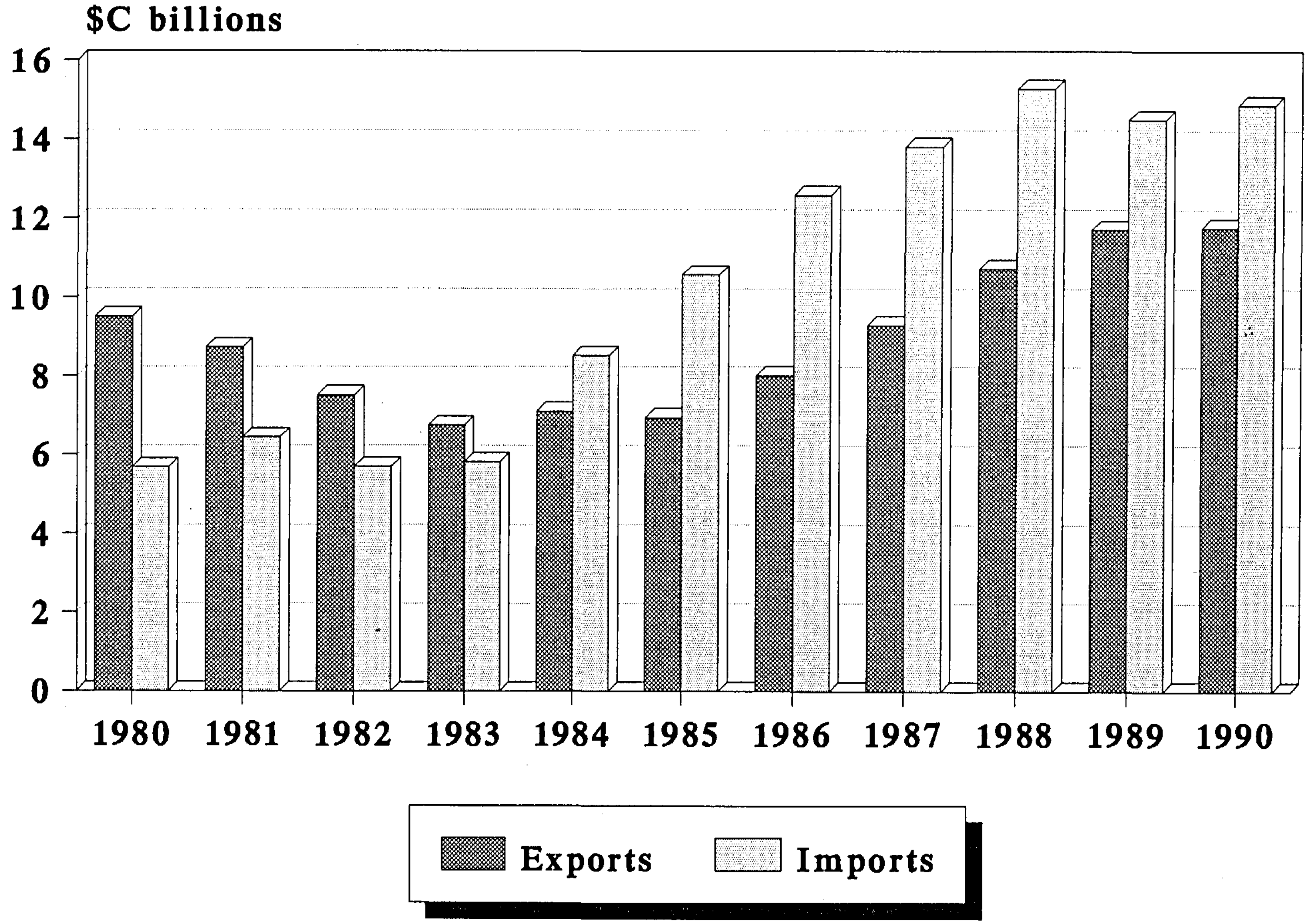
Source: Statistics Canada

U.S., JAPANESE FOREIGN DIRECT INVESTMENT IN THE EC, BY COUNTRY (1989/1990)



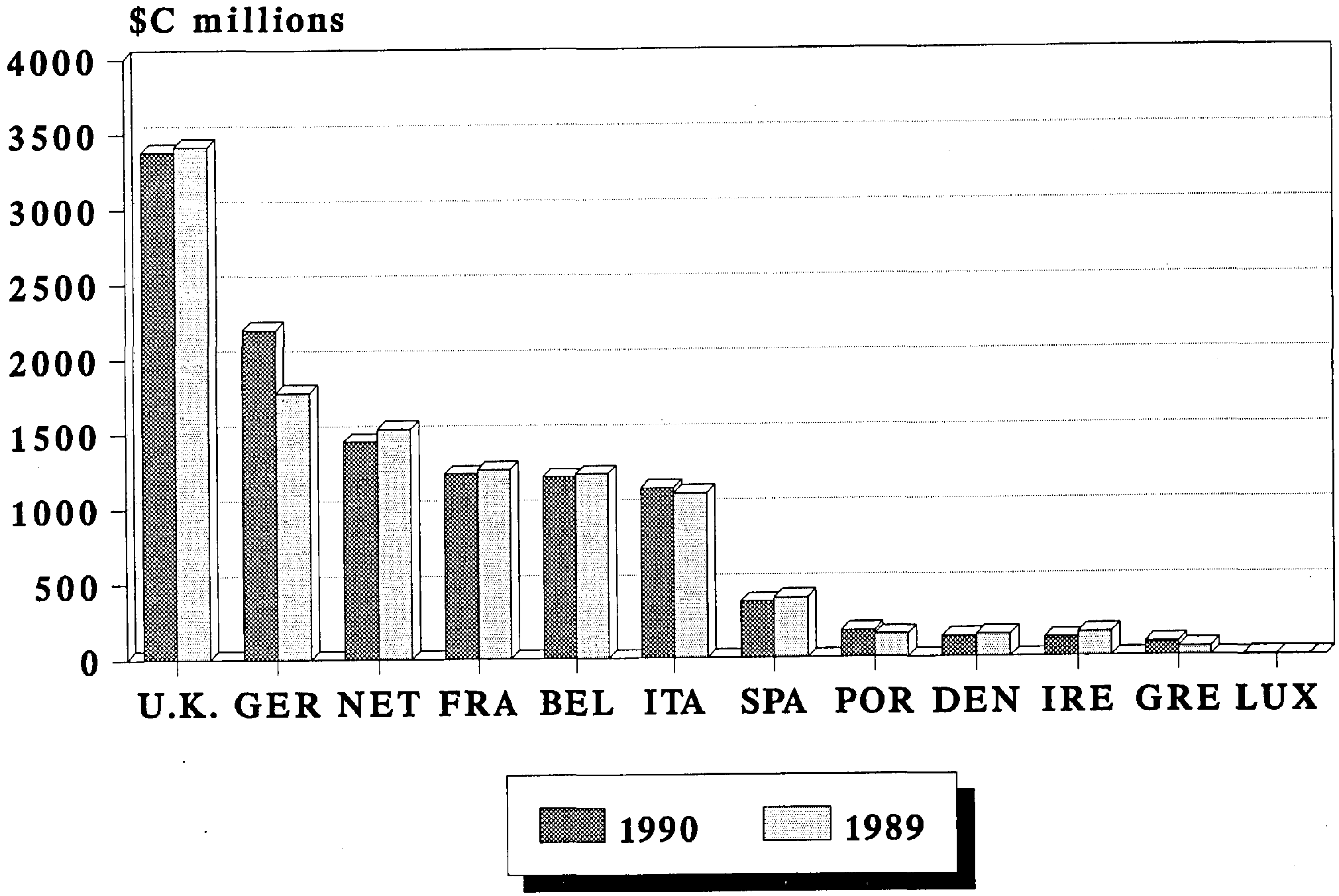
Source: U.S. Dept of Commerce; Agence Europe

CANADIAN TRADE WITH THE EC (1980-1990)



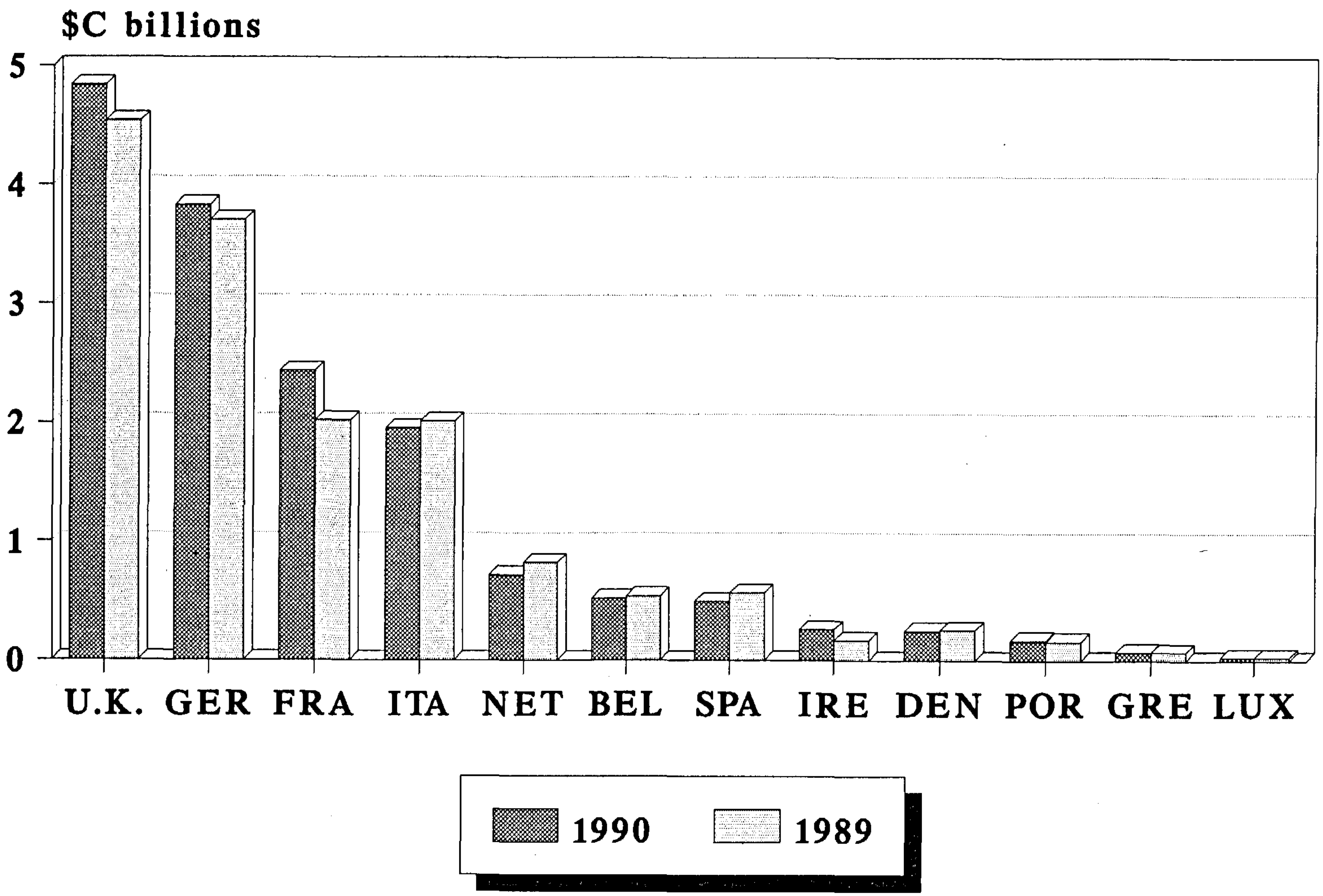
Source: Statistics Canada

CANADIAN EXPORTS TO THE EC, BY COUNTRY
(1989-1990)



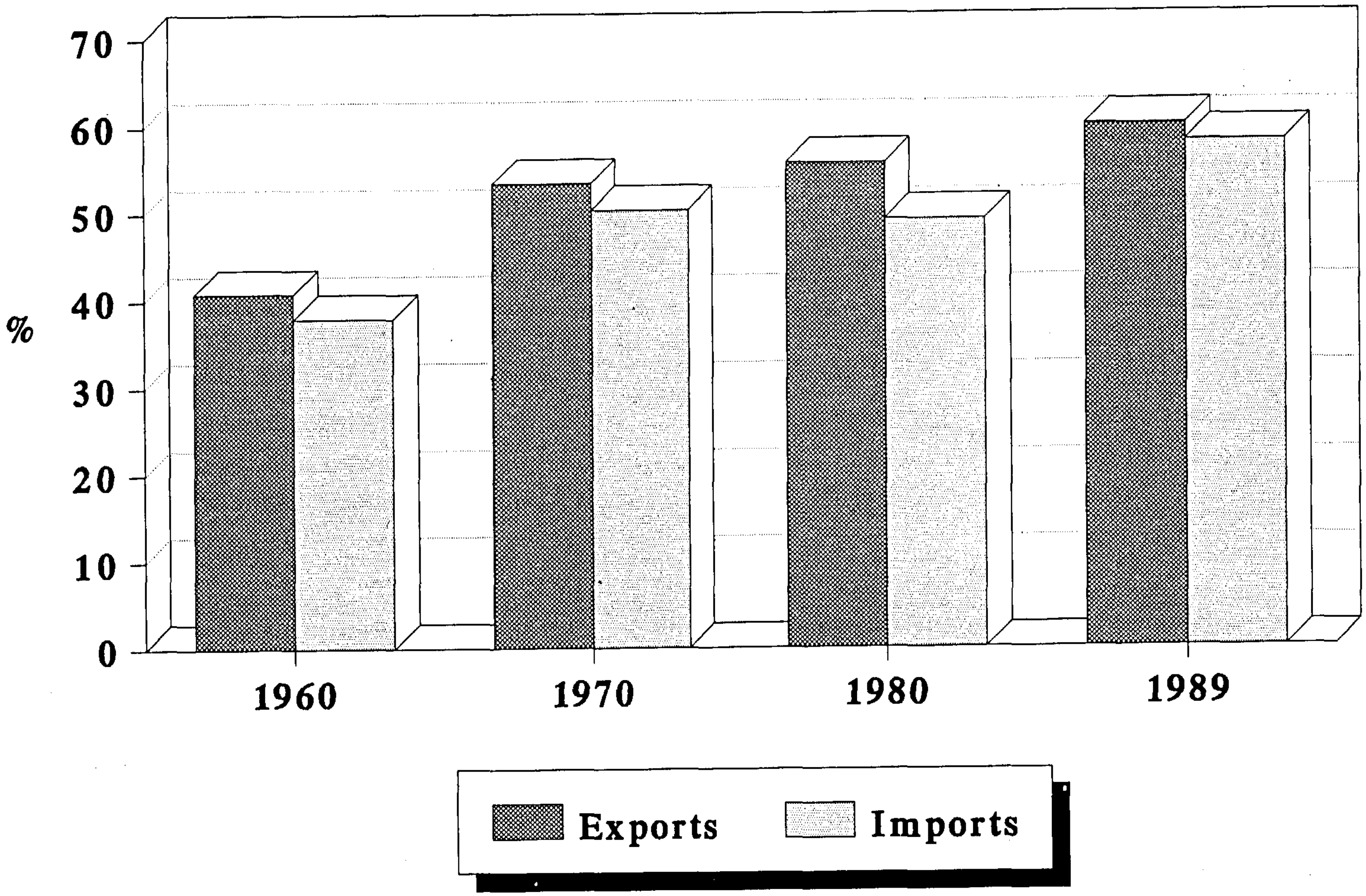
Source: Statistics Canada

CANADIAN IMPORTS FROM THE EC, BY COUNTRY (1989-1990)



Source: Statistics Canada

INTRA-EC TRADE AS % OF TOTAL EC TRADE (1960-1989)



Source: Eurostat

Appendix C

SUMMARY OF EC COMPANY LAW MEASURES

The following is a summary of principal Company Law Directives and Regulations, adopted and proposed. The date accompanying each adopted measure is the adoption date. Implementation dates often vary, for several reasons. For example, a particular country may be allowed longer delays in certain cases, a measure may be implemented on the expiry -- at different times -- of national laws, or a different schedule may apply to countries that became member states after other countries had already implemented a particular measure.

Measures Adopted

First Council Directive re Company Disclosure
(68/151)
March 9, 1968

Second Council Directive re Capital Requirements
(77/91)
December 13, 1976

Third Council Directive re Mergers of Public Companies
(78/855)
October 9, 1978

Fourth Council Directive re Annual Accounts
(78/660)
July 25, 1978

Sixth Council Directive re Division of Public Companies
(82/891)
December 17, 1982

Seventh Council Directive re Consolidated Accounts
(83/349)
June 13, 1983

Eighth Council Directive re Audits (84/253)
April 10, 1984

Eleventh Council Directive re Branch Disclosure
(89/666)
December 21, 1989

Twelfth Council Directive re Single-Member Private Companies
(89/667)
December 21, 1989

Council Regulation re European Economic Interest Grouping
(2137/85)
July 25, 1985

Measures Proposed

Fifth Council Directive re Structure of Public Companies

Tenth Council Directive re Cross-border Merger of Public Companies

Thirteenth Council Directive re Takeover and Other Bids

Council Regulation re European Company Statute

Council Directive re Employee Participation in European Company

REFERENCES

Texts of EC measures, both proposed and adopted, can be obtained from:

Delegation of the Commission of the European Communities
1110-350 Sparks Street
Ottawa, Ontario K1R 7S8
(613) 238-6464

Further sources of information are:

"Common Market Reporter."
CCH Canadian Limited
6 Garamond Court
Don Mills, Ontario M3C 1Z5
(Updated service - text and commentary)

"The Law of the European Community: A Commentary."
Matther Bender
11 Penn Plaza
New York, N.Y.
U.S.A. 10001
(Updated service - commentary)

"Business Operations" Series
Bureau of National Affairs Inc.
1231 25th Street NW
Washington D.C.
U.S.A. 20037
(Mainly tax analysis but also reference to company and related law. By country.)

"Guides to European Taxation."
International Bureau of Fiscal Documentation
PO Box 20237
1000 HE Amsterdam
The Netherlands
(Tax reporting and analyses. By country.)

Additional review and analysis of specialized areas of law -- for example, competition or intellectual property -- can be found in legal services that cover these issues on an international basis.

General summaries on EC business and related laws are published by all major international public accounting firms and major European law firms.

NOTES

1. Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and United Kingdom.

2. Canada does not have a bilateral treaty with Greece or Portugal.

External Affairs and International Trade Canada

Affaires extérieures et Commerce extérieur Canada