Chairman Cohen has implied that the requirements of the Investment Company Act of 1940 have somehow left investment company stockholders in a worse position than other corporate stockholders when dealing with a conflict of interest situation: viz.

"Thus, the congressional requirement of approval by the shareholders and a majority of the unaffiliated directors which was intended to act as a protection for the shareholders, has actually insulated the fees from judicial scrutiny and deprived the shareholders of the benefit of judicial protection they would otherwise have enjoyed." (Statement of Securities and Exchange Commission before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce on H.R. 9510 and H.R. 9511 on October 10, 1967, p. 40.)

It is true that approval of an advisory contract by disinterested directors or by stockholders has an effect on the manner in which the courts review the problem. However, it is not true that these requirements of the Act put the stockholders of an investment company in a different position from other corporate shareholders. There was nothing in the law prior to the Act which in any way precluded approval of an advisory contract by disinterested directors or by stockholders.

There have been many court decisions which have considered the role of independent directors, stockholders and the courts in resolving the potential conflict of interest problem. In fact, there are a number of cases dealing with arrangements similar to those in the investment company industry. For instance, such a pattern is fairly common in the hotel industry where the corporation owning the hotel will engage a management company to operate the hotel for a fee. This pattern is also found to a certain extent in the insurance industry. The important point, however, is that these cases concern corporations of all types and the principles applied are the same whether the corporation involved is an investment company or not.

A review of numerous decisions in this area indicates a framework for solving the conflict of interest problem as described below. Where there is a transaction in question, whether in the forms of a contract or compensation arrangement, which is between the corporation and a director or between the corporation and other corporations in which one or more directors have an interest, three basic situations present themselves. First, where the presence or vote of an interested director is needed for a quorum or for board approval; second, where the presence or vote of an interested director is *not* needed for a quorum or board approval; and third, where a majority of stockholders has approved of the transaction.

In summary of the review below: where interested directors are making their own judgment of a transaction, they have the burden of convincing a court that it is reasonable and fair. Because of this conflict of interest their judgment is not in issue. It is assumed to be non-objective and the terms of the transaction are directly considered by the court. However, when non-interested directors have applied their judgment, the assumption is that their judgment was correct or in the case of stockholder approval that they properly exercised their franchise. In order to invalidate the transaction in either of these cases, it must be shown that the transaction was so unreasonable or unfair that it was beyond the power of the directors to approve or of the majority stockholders to ratify the transaction to the detriment of the non-assenting stockholders.

1. VOTE OF NON-INDEPENDENT DIRECTORS NECESSARY FOR APPROVAL

If the transaction is approved by a board in which the presence or the vote of an interested director is necessary for approval, when any stockholder complains that the transaction is unfair or overreaching the directors who would uphold this transaction have the burden of proving that it is fair and reasonable and entered into in good faith. If they fail, the transaction will be rescinded and if injury has been suffered, damages will be recovered for what was essentially an invalid transaction.

Many different words are used to express the standard applied, but their import is clear. Because of the fact of self-dealing, where the vote of an interested director is necessary, the burden of showing that the arrangement is fair and reasonable is put on those who have the conflict of interest. Further, and most important, in this one instance the court itself decides whether the arrangements meets the standard of reasonableness, and then with great reluctance. However,