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## **Third-Party Committees and the *De Facto* Power of Soft Law: A Sociological Analysis of Corporate Compliance in Japan**

*Kota FUKUI*

### **Abstract**

In Japan, similar to other countries, corporate scandals constantly threaten the existence of companies. Scandals concerning famous companies are reported every week. Such scandals have become a serious problem in Japanese corporate society. This paper focuses on ‘third party committees’ (Daisansha I’inkai) established by companies to deal with such scandals.

A third-party committee is established by an organisation for dealing with various types of scandals, but primarily instituted for corporate scandals. The majority of committee members are lawyers, but sometimes they include CPAs and other related professionals. When a company discovers management problems, it is the manager who responds first. However, in cases where it is inappropriate for the management alone to address problems, such as when managers themselves are involved in scandals, an independent third-party committee is established to deal with the crisis in a neutral manner.

A third-party committee investigates the facts independently, clarifies the causes of scandal, and submits proposals to prevent recurrence of the events. However, this committee is established by a company only on contract basis, not on the basis of any legislation. The third-party committee is considered a unique scandal-remedying mechanism in Japan. This paper discusses what the third party committee is, what role it plays, and how to implement recurrence prevention measures.

### **I. Introduction**

There is no end to the list of scandals that throw companies and other organisations into an existential crisis.<sup>1)</sup>

This has led to the frequent use of ‘third-party committees’ as a way for companies or organisations to overcome the crisis triggered by such scandals.

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1) In this paper, “scandal” refers to criminal acts, violations of the law, and other improper acts that invite blame from society.

Third-party committees are established as a silver bullet for damage control to help not only companies, but also organisations such as schools, hospitals, and local governments, and to deal with scandals of varying character and scale. The society's expectations of third-party committees are very high; sometimes these committees are even used to deal with crisis situations at the national level.<sup>2)</sup> In the wake of a scandal in a company or organisation, the establishment of a third-party committee is typically entrusted to lawyers and other specialists. This committee is expected to develop preventive measures for future scandals from a neutral perspective and to engage in a certain level of intervention in the company or organisation based on those measures. Such committees can be referred to by many different names, such as *investigation committee*, *external committee*, *external investigation committee*, *independent investigation committee*, *special committee*, or *incident investigation committee*, and can likewise be involved with the company in question in various ways. It should be noted that third-party committees are used not only for crisis management when there is a scandal; they are sometimes established as neutral examining bodies that enable companies to handle anticipated conflicts of interest.

Generally, third-party committees are established as independent committees that conduct a neutral investigation within the organisation in question. What kinds of activities are expected of these third-party committees, what function do they serve, and how do they enforce preventive measures? In the following pages, I will consider these questions and others from a socio-legal perspective.<sup>3)</sup>

## II. Definition of Third-Party Committees

### A. Legal Definition

According to the basic definition stipulated in the Japan Federation of Bar Associations (JFBA) Guidelines, third-party committees are as follows:

...a type of committee that is established in cases where criminal acts,

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- 2) The establishment of four "incident investigation committees" (third-party committees) by the Diet, the government, citizens, and TEPCO in the wake of the Fukushima Daiichi nuclear disaster caused by the Great East Japan Earthquake of March 2011 is still fresh in our minds. See more details in METI Research Office, "The Fukushima Dai'ichi Nuclear Power Plant Accident and Four Investigation Committees" (*Fukushima Dai'ichi Genpatsu to Yottsuno Chōsa I'inkai*), *Chōsa to Jōhō*, vol. 756 (2012), 1–20.
  - 3) Corporate regulation by using social powers has been discussed in common law countries since Ayres and Braithwaite, see I. Ayres and J. Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford: Oxford University Press, 1992).

violations of the law, and other improper acts that invite blame from society have occurred or are suspected to have occurred in a company or organisation; is composed only of members independent from the organization; and conducts a thorough investigation to analyse the causes based on the expertise and experience of specialists, whereupon it makes recommendations for specific preventive measures and other policies as necessary.<sup>4)</sup>

Their objective is to restore the stability of the company or organisation and stakeholders' trust in it by conducting an investigation for the stakeholders and presenting them with the results thereof.<sup>5)</sup> However, third-party committees may not always be established in a form that complies completely with these guidelines, as they are not legally binding. This blurs the distinction between third-party committees and the 'internal investigation committees' established under the direction of the management.

The first point that should be clarified here is that organisations establish third-party committees at their discretion and on a contract basis. In general, these committees are comprised of legal experts, primarily lawyers under an oath of confidentiality,<sup>6)</sup> with membership extending to include specialists in skills related to the scandal and specialists such as Certified Public Accountants (CPA), as the circumstances dictate. Above all, third-party committees should be regarded as a means, developed through experience, for companies and organisations to self-cleanse in order to deal with scandals and other crises<sup>7)</sup>. Considering no parallels can be found for these committees in other countries, they should also be thought of as a unique crisis management mechanism developed in Japan.<sup>8)</sup>

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4) JFBA, "The Guidelines for Third-Party Committees of Japan Federation of Bar Associations" (2010), Part I, Preamble.

5) JFBA, "The Guidelines" (2010), Part I, Preamble.

6) Attorney-client privilege becomes important in cases where the scandal affects other countries and a civil suit may be filed by parties involved from countries that have a discovery system, such as the United States; as such, it has been noted that this is important to remember when a third-party committee's members are specialists other than lawyers. For more on this, see A. Shiozaki, "Recommendation to flexible use of the Guidelines for Third-Party Committees of Japan Federation of Bar Associations (*Daisansha I'inkai Gaidorain Danryokuteki Unyo no Susume*)," *Bizinesu Hōmu* 11, no.8 (August 2011): 104, section 3 (3).

7) N. Nakamura, "The Standards for the Trust of Third-Party Committees" (*Daisansha I'inkai no Shinraisei no Kijun*), *Kinyū Shōji Hanrei*, no. 1332. (2010): 1.

8) Likewise, see A. Takeuchi, "Current State and Prospect of Third-Party Committees after the JFBA's Guideline" (*Nichibenren Gaidorain-go no Daisansha I'inkai no Genjō to Kadai*),

**B. *Independence and Neutrality of Third-Party Committees***

The most important values of third-party committees are their independence and neutrality. Since they are at a distance from the organisation in question, these committees are expected to clarify the facts, investigate the causes of misconduct, and formulate preventive measures. Nevertheless, there is no such thing as completely unbiased independence and neutrality. Here, these terms should be taken to mean that there is no conflict of interest between the organisation in question and the committee; furthermore, they must be understood as relative.

If the task of a third-party committee is to persuade the organisation in question to cooperate affirmatively in its investigative activities, then such a committee, consisting entirely of outsiders, cannot do so sufficiently. Alternatively, a committee could involve people ‘on the inside’ to encourage more affirmative investigative cooperation and enable a deeper investigation of the cause. One can imagine situations in which this would also contribute to restoring ‘social trust’ (i. e., the trust of society as a whole) in the organisation in question.

In essence, the neutrality and independence of a third-party committee should not be formally judged only by the presence or absence of conflicts of interest. Instead, other conditions must be taken into account, such as whether the primary stakeholders have any formal objections to the membership of the committee, and whether it restores social trust, as opposed to worsening the situation.<sup>9)</sup>

**III. Activities and Functions Expected of Third-Party Committees****A. *Activities Expected of Third-Party Committees***

What kinds of activities are expected of third-party committees? Generally, they are (a) to clarify the facts of the case, (b) investigate the causes, and (c) formulate preventive measures for the future.<sup>10)</sup> This sometimes extends to include (d) determining the presence (or absence) and degree of responsibility of managers and others involved, and pursuing accountability, although it is difficult to consider this as a function specific to third-party committees because it is often ensured by establishing a separate committee when necessary.<sup>11)</sup>

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*Liberty and Justice (Jiyū to Seigi)* 64, no. 3 (2013): 56–59.

9) On this point, see Shiozaki, “Recommendation,” section 3. (6).

10) JFBA, “The Guidelines” (2010), Part I, Preamble.

11) JFBA, “The Guidelines” (2010), Part I, 1. (1), note 1.

### **1. *Clarifying the Facts of the Case***

When there is a scandal, the first task of a third-party committee is to clarify the facts of the case. If the scandal is serious enough to throw the entire organisation into crisis, then the first order of business is to understand the circumstances in detail: What happened? What is problematic about what happened? When did this problematic matter begin? Is it still happening? Who is involved? How is the problem worsening? How did the problem come to light? Who is impacted, and by how much? On this point, the JFBA Guidelines expects third-party committees to include quite a wide range of background information in their investigations, defining the facts to be investigated:

Firstly, the facts of the scandal, but also how it came to be, the motive for misconduct, its context, and whether or not there are similar cases as well as the internal controls that caused the said scandal, and issues in compliance, governance, and corporate culture.<sup>12)</sup>

### **2. *Investigating the Causes***

Parallel to the fact-finding work, the third-party committee is to investigate the causes of the scandal, taking into consideration the facts that have been identified. As the fundamental objective of the committee is to deal with the crisis, it is expected to determine the causes of the scandal and eliminate the causes that are unlikely. The causes to be investigated are numerous and vary according to the nature of the scandal; for example, they may include technical issues in the case of an accident or, in the case of malpractice, the reason for its occurrence, and aspects of the organisational culture that prolonged the problem.

### **3. *Formulating Preventive Measures***

To resolve a crisis caused by a case of organisational misconduct, it is important to ensure that similar issues will not arise in the future; third-party committees are strongly expected to take care of this. The legitimacy of a third-party committee depends on whether or not it can formulate effective preventive measures suited to the nature of the organisation. It may propose reforming the aspects of the organisational culture that caused the scandal, seek to introduce new internal check systems or, sometimes, upon determining the presence and degree (or absence) of responsibility of those involved, propose that the organisation deals with the issue in-house. However, the fundamental role of the third-party

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12) JFBA, “The Guidelines” (2010), Part I, 1. (1).

committee is to perform damage control for an organisation that has been rocked by scandal; pursuing the accountability of those involved is typically not part of its objectives and should be thought of as a secondary role.<sup>13)</sup>

### **B. Functions a Third-Party Committee Serves in Dealing with a Scandal**

What kind of contributions can a third-party committee make to a company or organisation that has fallen prey to scandal simply by clarifying the facts, investigating the causes, and formulating preventive measures? This is a problem related to the functions of a third-party committee. The following sections discuss three of these functions, which are also related to the time at which the committee is established.<sup>14)</sup>

#### **1. Crisis Management**

In the wake of a scandal, what companies and organisations need most immediately from third-party committees is crisis management.<sup>15)</sup> Therefore, third-party committees must be established quickly. They are not, however, expected to exercise power beyond the extent granted by the management; restructuring the organisation on behalf of the management and building a new management system is out of the question.<sup>16)</sup>

Nevertheless, there is no shortage of ways in which a third-party committee can address the organisational crisis brought about by the scandal. Particularly in situations where the management's involvement in the scandal has caused the current executives to lose stakeholders' trust, it is often only a third-party committee that can accomplish some form of damage control. In this sense, while certain limits are imposed on third-party committees, attending to crisis management in a company or organisation in the throes of scandal is their most important function.

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13) T. Ikeda, "What are Third Party Committees? From Serendipity to the Protection of Due Process of Law" (*Daisansha I'inkai to wa Nanimono ka?*), in *Festschrift for Tadashi Ishikawa-Sensei's 70<sup>th</sup>-Year-Old Birthday (Ishikawa Tadashi-Sensei Koki-Kinen Ronbunshū)*, Shojihōmu (2013): 1024–1026.

14) Ikeda, "What are Third Party Committees?" (2013), 1026.

15) T. Kunihiro, "Practical Analysis of a "Third-Party Committee," (*Daisansha I'inkai no Jitsumuteki Kentō*) 1<sup>st</sup> half, *NBL*, no. 903. (2009), 27 onward.

16) A third-party committee has neither the authority nor the ability to take complete control of the organisation's operations on behalf of management. If management permitted a third-party committee to do such things, it would probably result in a shareholder lawsuit.

## 2. *Maintaining Discipline in Capital Markets*

If the company in question is a listed company and the scandal revolves around fraudulent accounting, it will inevitably disrupt order in capital markets, and the disruption will be proportional to the size of the company. While securities and exchange commissions are established to avoid such situations and maintain order, some people are of the opinion that third-party committees must engage in efforts to strengthen market discipline by cooperating with securities and exchange commissions.<sup>17)</sup> Doing so – maintaining market discipline – is an essential prerequisite for a company or organisation to run in a sustainable and stable manner, and thus, it is in the common interest of all listed companies and organisations. Therefore, third-party committees must not ignore this interest, which means that maintaining discipline in capital markets, albeit partially, is another important function that third-party committees are expected to serve.

## 3. *Maintaining the Company's Value*

Corporations have many stakeholders – shareholders, employees, investors, consumers, the board of directors, and local residents – each with their own interests. From a short-term perspective, this means that what is expected of a third-party committee varies from one stakeholder to the next. However, over the medium and long term, it is in the interest of both the company and its stakeholders that the company is of benefit to society through an engagement in productive activities and/or provision of services. When a scandal arises, the deciding factor in maintaining or restoring the value of the company in question is the set of preventive measures formulated by the third-party committee.

Over the short term, it is conceivable that by conducting investigations to clarify the facts of a scandal, a third-party committee can negatively impact the value of the company in question. When the results of the investigation are released, stock prices may decrease, and the company may be forced to suspend its services or recall its goods, and employees may resign. However, even a company struck by a scandal can gradually restore its value by building up the confidence that such misconduct will not recur. In some cases, the ‘old guard’ may be pushed out but as the saying goes, ‘diamonds are formed under pressure’. Therefore, even

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17) K. Sasaki, “What is a Role of a Third-Party Committee Shown by the Securities and Investment Board?” (*Shōken Tōshi Tōkyoku ga shimesu Daisansha I'inkai no Yakuwari to wa*), *Bizinesu Hōmu* 10, no. 7 (July 2010): 66–70; T. Kunihiro, “Regulation on the Capital Market and a Third-Party Committee” (*Daisansha I'inkai to Shihon Shijō no Kiritsu*) *Kinyū Shōji Hōmu*, no. 1900. (2010), 97 onward.

if the committee's investigative activities lead to short-term losses, they must be understood as absolutely essential to maintain and restore the company's value over the medium and long term.

#### IV. Third-Party Committees as Hubs for the Observation of Observation

##### 1. *Why a Sociological Analysis of Third-Party Committees Is Necessary*

While third-party committees perform these functions, the preventive measures they formulate after their investigation are elaborate plans without effective reinforcement. How can a third-party committee's preventive measures be effectively enforced so that they contribute to restoring trust in a company after a scandal? I will now present socio-legal perspectives in order to analyse the enforcement of such preventive measures.

##### 2. *'The Observation of Observation' and its Function*

German sociologist Niklas Luhmann defines 'observation' as an act that has to do with how a person engaging in communication with another person assigns meaning to that communication.<sup>18)</sup> For example, when one person is involved in communication with another about the *scientific truth of some thing*, then the communication is observed as an exchange in a scientific system and arranged as such.<sup>19)</sup> If an exchange involves disputes over rights, obligations, and legality, is observed as legal communication, which entails the continuous occurrence of exchanges over *legal/illegal* or *having a right/not having a right* with reference to legal programmes.<sup>20)</sup>

However, such communication cannot reach a conclusion from the perspective of the disputing participants in the communication (a *first-order* perspective).<sup>21)</sup> That is, with questions such as *which is right and which is wrong* or *who has the right and who does not* remain unsettled, the communication can continue endlessly. Putting an end to this communication requires taking a step back from such exchanges and 'observing the observation' – the *second-order* perspective.<sup>22)</sup>

For example, suppose there is a dispute between A and B, in which A argues,

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18) N. Luhmann, *Die Wissenschaft der Gesellschaft*, 1. Auflage (Suhrkamp: Frankfurt am Main 1992), 73.

19) Luhmann, *Die Wissenschaft* (1992), 85.

20) N. Luhmann, *Das Recht der Gesellschaft*, 1. Auflage (Suhrkamp: Frankfurt am Main, 1993), 166; also see, Fukui, *Niklas Luhmann's Theory of Law (Hōriron no Rūman)* (Tokyo: Keisō Shobō, 2002), 56–58.

21) Luhmann, *Die Wissenschaft* (1992), 85–87.

22) Luhmann, *Das Recht* (1993), 71.

‘The right belongs to *me*’ and B argues, ‘No, the right belongs to *me*’. The ‘observation of observation’, in this case, is the *second-order* observation that enables one to consult legal programmes (such as statute law or precedent) and conclude, from a distance, that it is B who satisfies the legal requirements and is therefore the one to whom the right belongs.<sup>23)</sup> A court’s legal process is defined in the instance of this observation. I would like to emphasise here that third-party committees are also defined in the instance of the observation of *this observation*. Third-party committees clarify the facts and investigate the causes of a scandal in a neutral fashion, independently of the company struck by the scandal. They carefully examine the issue and formulate preventive measures by observing, from a distance, the organisation’s own observation.

Why is the ‘observation of observation’ significant? In communication, there is a blind spot in the observations of each participant. The participants cannot objectively observe their own (mis)conduct.<sup>24)</sup> If we apply this logic to a scandal, the organisation – the party at the first order level – is incapable of impartially judging such things as what aspects of its own organisational culture are problematic, what aspects of long-standing internal practices may be inappropriate, and whether these practices are legal. This is the blind spot of an organisation-as-participant. On the other hand, if a *third party* was to analyse the organisation’s observation from a distance, it could judge with greater clarity what is problematic, whether those practices are appropriate or inappropriate, and whether that constitutes a violation of the law.

The *raison d’être* of third parties is thus precisely that their ‘observations of observation’ can accomplish things that the organisation itself, the first party, cannot.

### 3. Enforcement of Preventive Measures

Even if a third-party committee clarifies the facts, investigates the causes, and uses that information to formulate preventive measures, it is all meaningless without compliance. A third party’s preventive measures, like to create a transparent structure of departments, are not legally binding. However, that does not necessarily mean that the preventive measures *will not* be followed; many organisations faithfully adhere to the measures formulated by their third-party

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23) Luhmann, *Das Recht* (1993), 61–62.

24) H. Maturana and F. Varela, *Der Baum der Erkenntnis: Die biologischen Wurzeln menschlichen Erkennens* (1984; München: Goldmann, 1987), 21–28.

committees.<sup>25)</sup>

Corporations and other organisations are exposed to fierce competition in global markets. They must outlast the competition in the global capital market, goods and services exchange markets, and the labour market. What assumes particular importance for a given organisation amid such competition is *trust*,<sup>26)</sup> from stakeholders both within and outside of that organisation and, if it cannot maintain this trust, it will not be able to survive in the global market.

In practice, earning, maintaining, and deepening internal and external stakeholders' trust is not easy.<sup>27)</sup> Moreover, in the wake of a scandal, a company temporarily loses this trust. To regain the trust lost due to a scandal, it is absolutely essential to (1) clarify the full story, investigate the causes, and formulate preventive measures, and (2) assure internal and outside stakeholders that those measures will be followed. This is *why* a company entrusts a neutral and independent third-party committee, and complying with those measures is *how* the company can regain lost trust and deepen that trust. Therefore, companies try to follow their third-party committees' preventive measures faithfully, whether they want to or not. The social pressure on a company to regain, maintain, and deepen trust is the *de facto* power of a third-party committee's preventive measures. Preventive measures thus function as a kind of soft law.

## V. The Committee for Rating Third-Party Committee Reports

Even when the preventive policies formulated by a third-party committee are implemented, situations often arise where it is difficult to trust those policies owing to inherent issues with the independence and neutrality of third-party committees. Some companies establish third-party committees merely to give the *impression* that they are recovering from a scandal. This means that the ranks of management that caused the scandal are using the third-party committee as a cover to protect themselves and hide the causes. In particularly egregious cases, this may damage social trust in the third-party committee system.

Consequently, Hideaki Kubori, Tadashi Kunihiro, and other sympathetic

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25) Depending on the rules for being listed on stock exchanges, not implementing preventive measures can cause a listed company to be delisted; in such cases, their *de facto* legal force is arguably in effect.

26) *Trust* in this context is, so to say, "Trust in trust", that is a mutual and reflexive trust in a society. See, N. Luhmann, *Vertrauen*, 4 Auflage (1968; München: Lucius & Lucius, 2000), 85–92.

27) Luhmann, *Vertrauen* (2000), 97.

attorneys spearheaded the establishment of the Committee for Rating Third-Party Committee Reports in April 2014. This committee chooses, examines, and rates third-party committee reports that are considered a matter of particular concern in society, and subsequently, announces the results to the general public.<sup>28)</sup> It also publicly recognises excellent investigative reports. In other words, it observes the ‘observation of observation’ of a company’s activities from a distance. Are such observations necessary?

Unfortunately, looking at third-party committees that were established as a way for a company to deal with a scandal, it is undeniable that there are some that serve as accomplices in the management’s self-protection or in hiding the causes of a scandal, rather than as a sincere means for preventing future scandals.<sup>29)</sup> Given this state of affairs, there is a certain degree of validity in bringing such instances to the public’s attention and curbing the use of third-party committees as a cover for wrongdoing. On the other hand, there is concern that such ratings may relativise the significance of investigative reports, which are entrusted to third-party committees by companies involved in scandals, and lead to infinite regress in the process of justifying the preventive policies of third-party committees. The Committee for Rating Third-Party Committee Reports should be used only as long as doing so does not negate the significance of a company’s wilful establishment of a third-party committee.

## VI. In Conclusion: On the Enforcement of Laws

Thus far, I have provided a general overview of the activities and functions expected of a ‘third-party committee’ engaged in crisis management for a company

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28) For more about the Committee for Rating Third-Party Committee Reports, please visit the following URL. The Committee’s purpose, members, and past ratings are published on the website <http://www.rating-tpcr.net/>, accessed November 6, 2020.

29) For instance, the Committee for Rating Third-Party Committee Reports unanimously gave an F rating to the *2015 Investigative Report on Poor Workmanship in the Ground Reinforcement for Runway C of the Tokyo International Airport* by TOA Corporation’s in-house investigative committee. According to the Rating Committee, the TOA investigative committee was a completely in-house committee, with the company’s vice-president as its chairman, a corporate lawyer as its vice-chairman, and full-time auditors, corporate officers, and the vice director-general among its members. What was problematized here is that TOA made a public announcement pretending that the committee’s report was impartial, while acknowledging that that committee was not a third-party committee. For more on this, please visit the following URL: <http://www.rating-tpcr.net/wp-content/uploads/fccfdeac65688725d484784e82ca152d10.pdf>, accessed November 6, 2020.

or organisation in the throes of scandal and a socio-legal analysis of the *de facto* power to enforce the preventive measures formulated by a third-party committee. In today's globalised society, the significance of legal standards applied with legal force by judiciaries and governments within the framework of sovereign nations is in relative decline. Their place has been taken by the *de facto* enforcement of various standards based on the *trust* of society as a whole or the evaluations of rating agencies.<sup>30)</sup>

However, it is problematic that this *de facto* enforcement lacks sufficient due process of law. State involvement in the enforcement of legal standards (e.g., the judiciary or government) generally provides opportunities for due process, such as a prior hearing or formal objections. In contrast, *de facto* power is vague and its enforcement is difficult to control. When a scandal arises in a company, the social reaction to the company's loss of trust sometimes manifests as harsh criticism ('bashing') on the internet, which can compel the company to make greater compromises than necessary, or even force it to exit the market in some cases.<sup>31)</sup> Considering that companies do not currently have any kind of 'right of rebuttal' with regard to such criticism, excessive dependence on *de facto* enforcement must be viewed with caution.<sup>32)</sup> It must be emphasised that several due process issues remain if the *de facto* enforcement of such standards is to be recognised from the perspective of procedural legal studies.

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31) SNS-based bashing sometimes delivers a decisive blow to corporations after a scandal.

32) The Committee for Rating Third-Party Committee Reports guarantees the opportunity for those involved in the investigative report in question to publish on its (the committee's) website any objections they may have to the rating. This is a consideration of due process with regard to those involved. For more on this, see: <http://www.rating-tpcr.net/about/#policy>, accessed November 6, 2020.

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