

ClientEarth v Shell plc Case Analysis: Directors' Duties, Derivative Actions and ESG

by Joseph Lewin

The High Court's recent decision in the case of ClientEarth v Shell plc [2023] EWHC 1897 (Ch) has significant implications for activist investors seeking to challenge the response of companies to climate-related risks, and for boards responding to challenges. It will provide reassurance to company directors.

ClientEarth, a climate change shareholder activist group, brought legal action aiming to challenge Anglo-Dutch oil and gas major Shell's response to climate change risks. The claim has been widely reported as a "world-first" that seeks to hold corporate directors personally liable through the court for allegedly failing to move away from fossil fuels fast enough.

ClientEarth was seeking a declaration in respect of Shell's directors' acts and omissions, together with a mandatory injunction that Shell (i) adopts and implements a strategy to manage climate risk in compliance with its directors' statutory duties, and (ii) immediately complies with an order of the Dutch court in separate litigation concerning Shell in the Netherlands.

In this judgment, the Court confirmed its earlier decision to reject the application by ClientEarth for permission to bring a derivative action against Shell's directors.

Derivative claims procedure

ClientEarth initiated legal proceedings as a "derivative claim".

A derivative claim is a claim brought by a shareholder or shareholders on behalf of the company against a third party (often the directors of the company) under s.260(1) Companies Acts 2006 (CA 2006).

The statutory procedure for bringing derivative actions effectively consists of two stages:

1. Prima facie case. A shareholder seeking to bring a derivative claim must make an

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application for permission to continue with the claim, and must show a *prima facie* case.

This application is made “on the papers”, i.e., by written application, without the need for a hearing.

Under s.263(2) CA 2006 the court must refuse permission if it considers that a person acting in accordance with the duty to promote the success of the company would not continue the claim, or if the act or omission from which the cause of action arises was authorised or subsequently ratified by the company.

If the court dismisses the application on paper, then, under CPR 19.15 the applicant / claimant has 7 days to request an oral hearing, at which point the claimant will invite the court to reconsider its application for permission.

2. Substantive application for permission.

Assuming that a *prima facie* case is established, the court will then order the defendant parties to respond to the permission application, and it will give directions for a substantive hearing of that application (CPR 19.15(12)). At this hearing the court retains a wide discretion to allow the claim to continue.

Exercising such discretion, the court takes into account all “relevant matters”, including a number of factors listed in s.263(3) CA 2006, such as: (i) whether the claimant is acting in good faith; (ii) the views of other shareholders that have no direct or indirect personal interest in the claim; and (iii) the importance that a person acting in accordance with his duty to promote success of the company would place on continuing the claim.

In the *ClientEarth v Shell plc* case, the Court’s earlier decision was made on papers. ClientEarth then exercised its right under CPR 19.15 to ask the court to reconsider its decision at an oral hearing.

The recent judgment given follows the oral hearing and consolidates the original judgment.

Directors’ duties relied on by ClientEarth

ClientEarth sought to rely on two of the statutory duties owed by Shell’s directors. These duties are common to all English companies, and are set out in CA 2006:

1. *Duty to promote the success of the company (s.172 CA 2006)*. This duty requires a director to act in in good faith when promoting the success of a company, for the benefit of the shareholders as a whole, having regard, amongst other matters, to a wide list of considerations. This includes the likely consequences of any decision in the long term and the impact of the company’s business operations on the community and the environment.
2. *Duty to exercise reasonable skill, care and diligence (s.174 CA 2006)*. This duty requires a director to exercise the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that might reasonably be expected of a person carrying out the functions that person

carries out, and the general skill and experience that director actually has.

ClientEarth also alleged that the directors owed six additional incidental duties specifically related to their duty to manage climate risk:

1. a duty to make judgements regarding climate risk that are based upon a reasonable consensus of scientific opinion;
2. a duty to accord appropriate weight to climate risk;
3. a duty to implement reasonable measures to mitigate the risks to the long-term financial profitability and resilience of Shell in the transition to a global energy system and economy aligned with the global temperature objective of 1.5°C under the Paris Agreement on Climate Change 2015;
4. a duty to adopt strategies which are reasonably likely to meet Shell's targets to mitigate climate risk;
5. a duty to ensure that the strategies adopted to manage climate risk are reasonably in the control of both existing and future directors; and
6. a duty to ensure that Shell takes reasonable steps to comply with applicable legal obligations.

ClientEarth also pleaded that there is a duty on a director who is aware of a court order to take reasonable steps to ensure that the order is obeyed. ClientEarth referred specifically to the order granted by the Dutch court against Shell, requiring Shell to reduce its group-wide CO2 emissions.

The pleaded breaches of duties included failures to set an appropriate emissions target and to adopt a strategy that would establish a reasonable basis for achieving net-zero targets, and a failure to comply with the Dutch court order.

ClientEarth sought a declaration that the directors had breached their duties and a mandatory injunction requiring the directors (i) to adopt and implement a strategy to manage climate risk in compliance with their statutory duties, and (ii) to comply immediately with the Dutch court order, with which it said that Shell had failed to comply.

ClientEarth decision

At the oral hearing, Mr. Justice Trower dismissed ClientEarth's application on the basis that the group had failed to establish a *prima facie* case for permission, as required by s.261(2) CA 2006.

The key takeaways from the judgment are summarised below:

1. Evidential burden on the claimant. The court emphasised that the purpose of the *prima facie* stage was to provide a filter for “unmeritorious” or “clearly undeserving” cases, which imposes an evidential burden on the claimant at the outset. The court must exercise a critical approach and take the evidence at its “reasonable highest”, which means that the evidence must be sufficiently substantial, without more, to justify the grant of relief. This confirmed that the approach to what amounts a *prima facie* case under CA 2006 is similar to the common law position, which is “a higher test than a seriously arguable case” as set up in Abouraya v Sigmund [2014] EWHC 277 (Ch).

2. Criteria to consider at *prima facie* stage. The court disagreed with ClientEarth's apparent suggestion that the discretionary factors listed in s.263(3) CA 2006 shouldn't be taken into account when deciding whether the evidence established a *prima facie* case. The same applied to the nature of the relief sought, which was as much a factor in the decision whether to grant permission as the nature of the breaches relied on. The court said that it could not see a legitimate benefit of the declaratory relief, emphasising that it's not the court's function to express views on directors' conduct which have no substantive legal effect.
3. Relevance of a shareholder's motivation, good faith and the views of other shareholders. One of the discretionary factors the court considered was whether the shareholder is acting in good faith in seeking to continue the claims. The court's conclusion was that the claimant needs to prove they are acting in good faith. Even if shareholders have an honest belief that the claim is in the best interests of the company, the good faith test may not be met if the primary purpose of bringing the claim is to pursue the shareholders' own political agenda. Court noted that ClientEarth's claim had been brought primarily to publicise its own agenda. It also gave weight to the fact that the relevant climate policy had been approved by over 80% of the other shareholders in Shell, and this "strongly" militated against the grant of permission. In the court's clear view, the proper forum for ClientEarth to voice its concerns was by vote of the members in general meeting.
4. The court is reluctant to interfere in company management decisions. It is for company directors, not the court, to determine how to promote the success of the company, but they must still have regard to the non-exhaustive list of factors under s.172 CA 2006, which include environmental and community considerations. It would also be incompatible with the subjective nature of a director's duty to act with reasonable skill and care (s.174 CA 2006) if the court was to dictate how the management of a business should be conducted.
5. The court rejected attempts to formulate new and absolute duties in respect of climate change. The court held that Shell's directors were not subject to these incidental duties for three key reasons: (i) they were inherently vague and incapable of constituting enforceable personal legal duties; (ii) they 'cut across' the basic principle of company law that it is for the directors to determine company strategy and to identify which, out of competing considerations, take precedence in meeting their obligation to promote the success of the company; and (iii) they were incompatible with the subjective nature of a director's duty to take reasonable care and skill in managing the business. The court noted that, at the oral hearing, there was a "subtle but important shift" in the way ClientEarth pleaded its case. It originally alleged that directors of companies "such as Shell" would be subject to these duties, but in oral argument its position was that the incidental duties arose logically once the directors had identified that Shell's climate strategy was a commercial objective which was most likely to promote the success of Shell. The court rejected that argument and commented that if it should not interfere with the commercial question of the strategy to be adopted, the same principle of restraint should be applied to the means by which that strategy was to be implemented.
6. The distinction between subjective and objective tests for breaches of directors' duties was also clarified. Breach of section 172 is subjective and requires proof of acting in bad faith. Breach of section 174 involves whether decisions fall outside the range reasonably available to directors at the time. The court emphasised that ClientEarth must show a *prima facie* case that directors couldn't reasonably conclude their actions were in Shell's interest.
7. Unless and until there is a 'universally accepted methodology' by which climate change action can be measured, it will be difficult to prove that directors have not acted reasonably in addressing climate considerations.

8. Under English law, there is no specific duty on directors to comply with an order of a foreign court, or to take steps to ensure the foreign court's order is obeyed.
9. The court will not grant mandatory injunctive relief (such as to implement climate risk strategies) which is too imprecise to be suitable for enforcement and would require constant supervision by the court. It is not the function of the court to adjudicate on whether the business is being run in accordance with the terms of the injunction.
10. Relevance of expert evidence. ClientEarth relied on evidence from one of its senior lawyers as to the alleged inadequacies in the directors' management of climate change risk. The court held that it could place very little weight on the lawyer's opinions, despite accepting that they were genuinely held. It rejected ClientEarth's submission that it was unreasonable to require or expect expert evidence at the *prima facie* stage. The conclusion was that the lawyer's evidence, unsupported by any expert analysis of why the directors got the section 174 balancing exercise so wrong as to be actionable, did not advance a *prima facie* case.

Impact on the ESG litigation

The ClientEarth claim has been dismissed after failing both in written submissions and during the oral hearing.

Notwithstanding the outcome of the potential appeal indicated by ClientEarth, the litigation has garnered substantial attention, consequently spotlighting Shell's policies that might have otherwise have not become public. Furthermore, Shell's shareholder meetings have undergone heightened scrutiny and review, potentially encouraging all boards to follow suit. To an extent, ClientEarth therefore achieved its objectives, emphasising the importance for company directors to prioritise climate change responsibilities.

Beyond the procedural challenges within the derivative claim process, the case emphasised the substantive challenges which are relevant to all ongoing and future climate change litigation, affecting both claimants and defendants: it is the lack of a universally agreed methodology to gauge and assess climate change actions.

Directors should also be cautious, ensuring that terms used in strategic documents and policies are substantive and as precise as possible, to avoid any disputes arising from differences in director / shareholder expectations. Given the escalating public consciousness surrounding environmental and de-carbonisation concerns, climate-related claims, even if ultimately unsuccessful, have the potential to inflict reputational harm on a company, impacting its stock value and ability to attract investments.

As for activists, this was a clear indication that the court will not accept wide-ranging assertions of climate change duty. Claimants will need to fully consider the remedies that they are seeking, and whether they are likely to constitute interference with a company's business, or are even unenforceable. The courts are unlikely to uphold broad injunctions mandating directors' compliance with general climate considerations, deeming them too vague to enforce and excessively burdensome on the court to oversee. However, the court's judgment does not rule out the possibility of such a claim succeeding in future, provided that it is more tightly drafted, and is tied to specific actions and projects.

While the pursuit of activist shareholders aiming to promote ESG agenda in corporate management is unlikely to cease, this recent decision offers a degree of reassurance to directors. It shows that, despite societal and political pressures in environmental and sustainability spheres, judicial intervention in corporate decisions will remain marked by caution. As emphasised by Mr Justice Trower in this case, the court will aim to refrain from prescribing how directors fulfil their duties. Additionally, it serves as a caution to shareholders, particularly those with minority stakes such as ClientEarth (which had only 27 shares in Shell), against initiating derivative claims with ulterior motives.

In another recent case McGaughey & Anor v Universities Superannuation Scheme Ltd & Ors [2023] EWCA Civ 873, the Court of Appeal rejected an appeal by academics seeking permission to bring a derivative claim against the directors of a university pension scheme for its alleged failure to divest from fossil fuels, criticising the use of the derivative claim process in attempt to challenge the management and investment decisions without any supportive evidence by reference to the *ClientEarth v Shell* decision. The Court of Appeal also held that '*the derivative procedural mechanism is not intended to enable the would be claimants to avoid other procedural hurdles*'.