ALERT MEMORANDUM

Derivative Claim Against Shell's Board by Climate-Change Activist Shareholder is Refused Permission to Proceed

May 31, 2023

On February 9, 2023, NGO ClientEarth sued all eleven members of the board of directors of Shell plc before the English High Court, for allegedly failing to take steps to protect Shell against climate-change-related risks (see our alert memorandum of February 22, 2023). Our follow-up alert memorandum of April 17, 2023, also set out some answers to some common questions on derivative claims in the context of ESG litigation.

On May 17, 2023, the Court refused to continue the claim. ClientEarth has been granted an oral hearing of its request to reconsider the decision.

The lawsuit is one of the first cases of its kind in Europe, in taking action against individual board members with respect to climate matters. ClientEarth alleged that the directors had breached their statutory duties to protect Shell, and sought a mandatory injunction requiring the directors to (1) adopt and implement a strategy to manage climate risk; and (2) comply immediately with the May 2021 judgment of the District Court in The Hague (the "2021 Shell Judgment"), which ordered that Shell cut its greenhouse gas emissions by 45% by 2030 compared to 2019 levels, in line with the Paris Agreement.

This alert briefly summarises the case's arguments, the judge's decision in refusing permission and the case's wider context.

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I. Background

Since its establishment in 2007, London-based NGO ClientEarth has been an active environmental litigant, with 170 lawsuits pending against governments and large corporates, and initiatives spanning more than 50 countries.

Section 260 of the UK Companies Act 2006 (the "CA 2006") permits a shareholder to bring a claim on behalf of the company against its directors in respect of certain causes of action, including breach of the directors' duty of care towards the company. The claim is brought for the benefit of the company (rather than the individual shareholders promoting the claim).

A shareholder requires the permission of the court to continue a derivative claim.

II. Submissions

The breaches specified by ClientEarth to seek permission fall into three categories:

1. A failure by the board to set an appropriate emissions reduction target;
2. The directors' strategy as regards achieving the net zero target ("NZ target") and Paris Agreement alignment; and
3. A failure to comply with the 2021 Shell Judgment.

At the first part of the permission stage the High Court makes a decision on the papers. Although not usual, alongside ClientEarth's pleaded claim, the court considered written submissions made by Shell.

III. Decision

(a) Permission

The court made clear that the reason a shareholder must obtain permission to proceed with a derivative claim is that the claim is an exception to one of the most basic principles of company law: a company should determine whether or not to pursue a cause of action available to it, rather than the shareholders.

In order to give permission to proceed, the court must be satisfied that the shareholder has established a good *prima facie* case, which, per *Abouraya v Sigmund* [2014] EWHC 277 (Ch), is a *"a higher test than a seriously arguable case",* at least with respect to claims brought under the common law rules. The court applied the rigorous test established in *TMO Renewables v Yeo and others* [2021] EWHC 2033 (Ch) that ClientEarth must show a *prima facie* case that there is no basis on which the directors could reasonably have come to the conclusion that the actions they have taken have been in the interests of Shell.

Under s.263 of the CA 2006, the court is required to refuse permission to continue the derivative claim in certain circumstances, such as where it finds that (a) a person acting in accordance with the duty under s.172 of the CA 2006 to promote the success of the company would not seek to continue the claim; or (b) any act or omission from which the action arises has been authorised or ratified by the company before or since it occurred.

If a *prima facie* case is not established permission should not be given, but the claimant can ask (within seven days) for an oral hearing to reconsider the decision.

(b) Duties

Statutory duties

The director duties relied on by ClientEarth include two of the statutory general duties owed by directors to the company pursuant to s.170 of CA 2006:

1. the duty in good faith to promote the success of the Company for the benefit of its members as a whole, having regard, amongst other things, to a number of identified factors, including the likely consequences of any decision in the long term, the interests of employees, the need to foster business relationships, the impact of the company's operations on the community and the environment, the desirability of maintaining a reputation for high standards of business conduct, and the need to act fairly between members (s.172 of CA 2006); and
2. the duty to exercise reasonable care, skill and diligence (s.174 of CA 2006).

Incidental duties

ClientEarth argued the duties extend to "necessary incidents" of the statutory duties including to:

1. make judgments regarding climate risk that are based upon a reasonable consensus of scientific opinion;
2. accord appropriate weight to climate risk;
3. implement reasonable measures to mitigate risks to long-term financial profitability and resilience of Shell in the transition to a global energy system aligned with the Paris Agreement;
4. adopt strategies reasonably likely to meet Shell's climate risk mitigation targets;
5. ensure strategies adopted are reasonably in the control of (both existing and future) directors; and
6. take reasonable steps to comply with legal obligations.

Shell argued that these incidental duties are vague and incompatible with the subjective nature of the duty under s.172, and that it is for the directors to determine the weight to attach to non-exhaustive factors referred to in s.172 of the CA 2006.

The court held the incidental duties that Client Earth was contending for sought to impose specific obligations on the directors notwithstanding the well-established principle that it is for the directors to determine how best to promote the success of a company for the benefit of its members.

Additional duties

ClientEarth also pleaded that under the common law of England and Dutch law respectively, a director who is aware of a court order is under a duty to take reasonable steps to ensure that the order is obeyed. Shell argued there was no recognised duty owed by directors to a company to ensure they comply with the orders of a foreign court.

The court agreed with Shell, holding that (i) the nature and extent of the Directors' duties to Shell are governed by English law as the law of Shell's incorporation; and (ii) affirming that there is no English law duty separate or distinct from the general duties owed by the Directors to Shell under CA 2006, which requires them to take reasonable steps to ensure that the order of a foreign court is obeyed.

(c) <u>The alleged breaches</u>

The breaches of duty alleged by ClientEarth fall into three categories:

1. A failure by the board to set an appropriate emissions target. ClientEarth's position is that an absolute emissions target to be met before 2050 is required, and the directors' decision to set Carbon Intensity Targets is inadequate. In particular ClientEarth argues that the directors have failed to ensure that Shell has a measurable and realistic pathway to meeting the NZ target;
2. The directors' strategy as regard management of climate risk does not establish a reasonable basis for achieving the NZ target and are not aligned with the Paris Agreement; and
3. The directors have failed to comply with the 2021 Shell Judgment. Client Erath alleges that although the 2021 Shell Judgment determined that Dutch law imposed a 45% emission reduction obligation on Shell to be achieved by 2030, the Directors have not prepared a plan to ensure timely compliance.

The court held ultimately that there are a number of "fundamental" reasons why ClientEarth's allegations do not establish a *prima facie* case.

1. Firstly, the evidence presented by ClientEarth does not establish a case that the directors are managing Shell's business risks in a manner which is not open to a board of directors acting reasonably.
2. Secondly, the evidence does not establish that there is a universally accepted methodology as to the means by which Shell might be able to achieve the reductions referred to in its Energy Transition Strategy ("ETS"). The law respects the autonomy of decision making of directors and their judgments on how best to achieve results which are in the best interests of their members as a whole.
3. Thirdly, in light of the fact that Shell's directors do in fact have certain relevant policies and targets, the evidence would

> have needed to, but does not, engage in the issue of how the directors have allegedly gone so wrong in their *balancing* of multiple factors that no reasonable director could properly have adopted the approach that they have. The court held this is a "fundamental defect" in ClientEarth's case because it ignores the fact that the management of a business of the size and complexity of Shell will require the directors to take into account a range of competing considerations.

As to the alleged breach relating to compliance with the 2021 Shell Judgment, the court considered that the Dutch Court had accepted that Shell was not at the time acting unlawfully and that it was a matter for Shell as to how it exercises its discretion to comply with the obligations imposed by Dutch law. This, it was held, cuts across the suggestion that the directors are under a duty to comply with the 2021 Shell Judgment in any manner other than compliance with their duties to do what would promote the success of the company.

(d) Relief sought

The court commented that it will not order a mandatory injunction if constant supervision is required and in that vein, the orders sought by ClientEarth, to implement strategies to manage climate risk and comply with the 2021 Shell Judgment, are insufficiently precise to allow enforcement.

(e) Refusal of permission

The court therefore considered that ClientEarth had not established a prima facie case, and that a person acting in accordance with s.172 of the CA 2006 would not seek to continue the claim. On that basis, the court refused ClientEarth permission to continue the claim.

In refusing permission, the court also had regard to the factors set out in s. 263(3) and (4) of the CA 2006. With regard to the question of whether the ClientEarth would be acting in good faith in seeking to continue the claim (s. 263(3)(a) CA 2006), the court held that the fact that ClientEarth only holds 27 shares in Shell gives rise to an inference that its real interest is not how best to promote the success of Shell for the benefit of its members as a whole, but that, instead, ClientEarth may be driven by a collateral motive.

Considering the question of evidence before the court as to the views of members of the company who have no personal interest, direct or indirect, in the matter (s. 263(4) CA 2006), the court noted the strength of the members' support for the directors' strategic approach to climate change risk (Shell's ETS was supported by 88.4% of the votes cast by its members at the 2021 AGM, and by 80% of the votes at the 2022 AGM). By comparison, the court considered the support which ClientEarth had received for its claim from members to amount only to "a very small proportion of the total shareholder constituency". On that basis, the court considered that "the level of member support for the ETS and its progress would count strongly against the grant of permission".

IV. Next Steps

ClientEarth has confirmed that it has asked for an oral hearing to reconsider the decision. The High Court has granted the hearing.

V. Commentary

It is clear the court is, as it always has been, reluctant to interfere in company management decisions. The court will generally take the approach that it is for the directors themselves, rather than the court, to determine how best to promote the success of the company.

The court also clarified that the law does not impose more specific duties outside of the general statutory duties set out in the CA 2006, which require directors to have regard to many factors in determining how best to promote the success of the company for the benefit of its members as a whole.

Further, in a world where climate litigation is rising, it is interesting to note the court referenced ClientEarth's motivations in bringing the claim. This suggests that, at least in the case of derivative claims, the court will consider if there is an ulterior motive behind the claim which is not solely related to promotion of the success of the company as a whole. Whilst ClientEarth asserted the claim was brought for the benefit of Shell's members as a whole with the aim of protecting its long term value, the court did not agree.

The procedural and substantive hurdles mean that the pursuit of derivative claims is uncommon and challenging in the UK. Nonetheless, we anticipate that litigation tools will continue to be used by well-resourced activists to generate publicity and put pressure on UK public company boards. It is very likely that we will see an increasing trend of such cases being brought and other corporate remedies being used to pursue climate-motivated agendas.

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