First of its kind "derivative action" climate case falls at the first hurdle

In a judgment handed down on 12 May 2023, the English High Court has refused permission for UK environmental NGO ClientEarth to continue "derivative claims" on behalf of Shell against its directors in connection with their alleged failure to ensure that Shell adopted and implemented an energy transition strategy that aligns with the Paris Agreement on Climate Change 2015 (the **Paris Agreement**).

In his judgment, Mr Justice Trower found that ClientEarth had failed to establish a prima facie case that the directors breached their duties to Shell, whilst noting that there could be some substance to Shell's submissions that ClientEarth, as the holder of only 27 shares in the company, was pursuing the claim out of its own policy interests, rather than in the interests of shareholders as a whole.

The judgment offers welcome assurance to directors as to the scope and content of their duties to companies and shareholders, confirming that the issue of how best to meet climate targets is an issue of business judgment for the directors with which the English courts will be reluctant to interfere. It also suggests that pressure groups who purchase shares in companies in order to bring derivative claims may face difficulty in demonstrating that they are acting in the interests of shareholders as a whole, rather than seeking to advance their own policy goals. This highlights the difficulties of bringing claims in the English courts based on directors' duties as a strategy to further climate change objectives.

Background

ClientEarth's claim is the first climate case of its kind in the UK. It sought to hold directors personally responsible for a company's failure to adequately address climate change risk under the "derivative claims" procedure in the Companies Act 2006 (**Companies Act**), through which shareholders may bring a claim on behalf of a company against one or more of its directors for breach of their duties to the company.

The Companies Act requires directors "*to have regard to… the impact of the company's operations on the community and the environment*" but this is in the context of their duty to promote the success of the company for the benefit of its members as a whole. As such, the duty is still owed to the company rather than third parties who may suffer losses as a result of climate change. Accordingly, in order to bring the claim, ClientEarth had to buy shares in Shell and frame the claim as a breach of the directors' duties to the company itself.

A derivative claim requires the court's permission to proceed and the court must dismiss any application if it appears that the application itself and the evidence filed in support of it do not demonstrate that the applicant has a *prima facie* case. Permission to proceed is first considered "on the papers", i.e. without a hearing, and this judgment was handed down following that initial stage.

Alleged breaches of duties

The duties relied on by ClientEarth included those under section 172 (duty to promote the success of the company) and section 174 (duty to exercise reasonable care, skill and diligence) of the Companies Act. ClientEarth also relied on alleged breaches of a number of specific "incidental duties" in relation to climate related risks, which were said to arise from those statutory duties.

ClientEarth alleged that the directors were under a duty to:

(i) make judgements regarding climate risk based upon a reasonable consensus of scientific opinion;

(ii) accord appropriate weight to climate risk;

(iii) 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 (**GTO**);

(iv) adopt strategies which were reasonably likely to meet Shell's targets to mitigate climate risk;

(v) ensure that the strategies adopted to manage climate risk were reasonably in the control of both existing and future directors; and

(vi) ensure that Shell took reasonable steps to comply with applicable legal obligations.

ClientEarth alleged that the directors had breached their duties to Shell in connection with the company's climate change risk management strategy in a number of key respects, contending that:

(i) the directors had failed to ensure that Shell had a measurable and realistic pathway to meeting the target set by the Board of being net zero by 2050 and, in particular, that there was no reported pathway to reduce Shell's Scope 3 emissions, and there were inadequacies in the pathways towards Scope 1 and 2 emissions reductions;

(ii) the climate change risk management strategy prepared by the directors did not establish a reasonable basis for achieving the net zero target, because it was reliant on nascent ineffective, carbon capture storage technologies as well as nature-based offsetting solutions, rather than targeting reductions in Shell's fossil fuel business – instead Shell proposed to make significant new investments in fossil fuel projects, particularly natural gas; and

(iii) the directors had failed to ensure that Shell complied with the order of the Dutch court in *Milieudefensie v Shell*[1], which determined that Dutch law imposed a 45% emissions reduction obligation on Shell to be achieved by 2030.

ClientEarth alleged that these failures increased Shell's exposure to:

(i) the risk of financial losses due to lower demand and lower margins for oil and gas products;
(ii) regulatory risk such as the imposition of carbon pricing and restrictions on carbon emissions; and
(iii) stranded asset risk in the form of assets already acquired which may become unviable or less profitable due to climate risk.

The relief sought by ClientEarth was relatively novel. As none of the risks that it identified had yet eventuated - and Shell had not yet suffered any loss as a result – the claim did not seek damages for any such losses, but instead asked for a declaration that that the directors had breached their duties and a mandatory order (injunction) requiring them to:

(i) adopt a strategy to manage climate risk in compliance with those duties; and
(ii) comply with the Dutch court order.

[1] https://blog.allenovery.com/aoblog/corporate_nl/dutch-court-orders-shell-to-reduce-co2-emissions-by-45

Decision

In dismissing the application, Trower J found that, in order for ClientEarth to make out its *prima facie* case, it needed to establish on the evidence that there is no basis on which the directors could reasonably have come to the conclusion that the actions they have taken in relation to Shell's climate change strategy have been in the interests of Shell, and its members as a whole. ClientEarth failed to pass this onerous test, which requires something more than a "*seriously arguable case*".

The judgment made the following key points:

(i) The Court emphasised the well-established principle that it is a matter for the company (acting through its directors), rather than one or more of its shareholders, to determine whether or not to pursue a course of action available to it. The court will be reticent to act as a "supervisory board" or intervene in this commercial decision-making process except in clear cases.

(ii) Without any evidence that there is a universally accepted methodology as to the means by which Shell might achieve its reduction targets, ClientEarth was also unable to make out its allegation that "no reasonable board of directors" would conclude that the pathway to achieving such targets was the one in fact adopted by Shell's board.

(iii) The Court also confirmed that the law would not superimpose on the statutory duties specific obligations as to what is and what is not reasonable and/or in the best interests of the company in every circumstance.

(iv) As such, the Court rejected the argument that the directors were subject to the "incidental duties" identified in ClientEarth's submissions, on the basis that such duties would impose specific obligations on directors as to the management of Shell's affairs. Such specific obligations, the Court said, would inappropriately cut across the directors' general duty to have regard to the many competing considerations as to how best to promote the success of the company for the benefit of members as a whole.

(v) The Court further confirmed that there is no established English law duty, separate or distinct from the general duties owed by directors under the Companies Act, which requires directors to take steps to ensure that a company complies, or takes steps to comply, with a foreign court order against it.

(vi) In relation to the proposed injunction, the Court noted that it will not offer relief that would require ongoing oversight from the court as to whether or not a business is being run in accordance with such relief.

Key takeaways

The key point arising from the judgment is that it is for directors, and not shareholders, to determine how to appropriately manage a company's affairs and this applies particularly strongly to difficult questions of how a company should go about managing the transition to net zero.

As the judgment points out, there are a number of competing considerations, and there is no "universally accepted methodology" as to the means by which Shell might achieve its emission reduction targets. This was not a situation where Shell had no climate reduction policy at all – instead ClientEarth just sought to argue that that policy was "manifestly unreasonable". However, ClientEarth was unable to demonstrate how the directors had "*gone so wrong in the balancing and weighing of the many factors which should go into their consideration of how to deal with climate risk, … that no reasonable director could properly have adopted the approach that they have*". This balancing exercise was a "*classic management decision with which the court is ill-equipped to interfere*".

This respect for their business judgment should give considerable comfort to directors who can demonstrate that they have properly considered the climate risks facing their business and weighed up the competing considerations. This emphasises the need for directors to ensure that they have a carefully formulated climate transition strategy, incorporating expert advice where appropriate, and that this is kept under review at board level, with the competing factors identified and debated.

This is not to say that directors could never be liable in relation to climate issues. From the judgment, it can be seen that a board that made a deliberate decision to ignore climate risks and did not have a strategy in place, and had made no attempt to weigh up the various factors, might be held liable. Lord Sales, a Justice of the UK Supreme Court, made the following comment in a speech to the AngloAustralian Law Society: "*Under certain circumstances … companies' interests may be so implicated by climate change effects that [directors' and officers'] general fiduciary and due care obligations actually require them to cause their companies to take action to reduce their contribution to climate changing activity*." Alternatively, if a major climate issue were identified by the board, but was deliberately concealed rather than addressed, this might not only give rise to securities law claims by shareholders, it could also expose the directors to claims for breach of duty to the company.

ClientEarth has requested an oral hearing to reconsider the decision. Given the difficulties identified in this first judgment, it seems unlikely that it will be successful in persuading the Court at that hearing to take a different view, but directors of corporates facing similar challenges and others involved in climate transition issues will nonetheless be watching with interest.

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