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ClientEarth v Shell: What future for derivative claims?

Lord Robert Carnwath

A Climate Change Laws of the World insight

February 2024

Grantham Foundation for the Protection of the Environment

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The views expressed in this note represent those of the author and do not necessarily represent those of the host institutions or funders. The author has no relevant financial or non-financial interests to disclose.

This note was first published in February 2024 by the Grantham Research Institute on Climate Change and the Environment.

Suggested citation: Carnwath R (2024) *ClientEarth v Shell: what future for derivative claims?* London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science.

ClientEarth v Shell: What future for derivative claims?

Introduction

This note comments on the case *ClientEarth v Shell Board of Directors*, heard by the High Court in London in 2023. The claimants alleged that the directors of Shell, in their decisions relating to the management of climate change risk, had failed to comply with their duties under the Companies Act 2006. The alleged failures related to their adoption of an overall target to become a net zero business by 2050 without implementing policies and plans that could reasonably be expected to meet that target. The High Court dismissed the claim, holding that there was no prima facie case.[1] Leave to appeal was subsequently refused by the Court of Appeal.

The legal framework

The Companies Act 2006 was the culmination of a major law reform programme led by the Law Commission, mainly under my predecessor as Chairman, Mary Arden J, and completed during my own period of office.[2] To a large extent, it represented a consolidation of the existing legal framework, statutory and case law, but it also included some significant reforms. Two innovations were the codification of directors' duties (sections 170–77) "based on certain common law rules and equitable principles as they apply in relation to directors" (s 170(3)); and a new statutory provision for derivative actions by shareholders (s 260).

The former was notable for including, for the first time, a specific reference to the environment. Section 172(1) states that:

> "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
>
> (a) the likely consequences of any decision in the long term...
>
> (d) the impact of the company's operations on the community and the environment."
>
> Section 174 sets out the duty of a company director to "exercise reasonable care, skill and diligence", defined as:
>
> "...the care, skill and diligence that would be exercised by a reasonably diligent person with:
>
> (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company.
>
> (b) the general knowledge, skill and experience that the director has."

Section 260 provided a new procedure for shareholders to bring an action in the name of the company by a:

> "Derivative claim... in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company".

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[1] The initial decision was made on the papers, and confirmed following an oral hearing ([2023] EWHC 1897 (Ch) Trower J). Paragraph references in this article are to the latter judgment.

[2] See in particular the reports of Shareholder Remedies LC246 (1997); Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties LC261 (1999).

As explained in the Explanatory Notes to the Act, this followed the recommendation of the Law Commission:

> "491.The sections in this Part do not formulate a substantive rule to replace the rule in *Foss v Harbottle [1843]*, but instead reflect the recommendation of the Law Commission that there should be a "new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action" (Shareholder Remedies, paragraph 6.15). In line with the recommendations of the Law Commission, the derivative claim will be available for breach of the duty to exercise reasonable care, skill and diligence, even if the director has not benefited personally, and it will not be necessary for the applicant to show that the wrongdoing directors control the majority of the company's shares."

The statute includes protection against frivolous claims. It requires an initial application to the court for permission to continue the claim (s 261). The court must first consider whether the application and the evidence filed by the applicant disclose a "prima facie case for giving permission", and if not must refuse permission at that stage (s 261(2)(a)). In addition, the court is required (by s 263) to take into account certain matters, including (s 263(2)(a)) "whether the member is acting in good faith in seeking to continue the claim".

Under the applicable rules (CPR19.15), the initial decision is made on the papers, but the claimant can request a hearing. The company must be notified of the claim, but is not made a respondent at that stage. The Practice Direction (CPR PD 19A.2) makes clear that the decision at this stage will "normally" be made without the involvement of the company, and that if "without invitation from the court" the company takes an active part, it will not "normally" be allowed any costs of doing so.

The ClientEarth case

In this case, as already noted, the initial decision that there was no prima facie case was made on the papers and confirmed following an oral hearing. Although not made a respondent at that stage, Shell had put in a "lengthy written submission", which the judge "took into account" (para 9), although there is surprisingly little reference to it in the judgment. Shell had also participated (by no less than three leading counsel and one junior counsel) at the oral hearing.

The evidence adduced by ClientEarth was described by the judge as "voluminous" (JT para 40), principally in the form of a witness statement by a ClientEarth lawyer, Mr Benson, "directed at what he explains is ClientEarth's central allegation that by adopting and pursuing an inadequate [energy transition strategy], the directors are mismanaging the material and foreseeable risk that climate change presents to Shell". The length of the evidence may have encouraged the belief that the issues were unusually complex and unsuitable for resolution in proceedings of this kind. Mr Benson was in effect trying to prove a negative. He needed to put before the court a complete picture based on reputable third-party sources, and from Shell's own disclosures, to support the case that Shell's directors were failing to adopt policies that were capable of achieving their publicly stated goals.

However, in essence, ClientEarth's case (at least, as it emerged in oral argument – para 24) was relatively simple, in both fact and law.[3] The Shell directors had adopted a so-called 'energy transition strategy' (ETS), setting an overall target to become a net zero business by 2050, also complying with the global temperature objective ("GTO") of 1.5°C under the Paris Agreement on Climate Change 2015.

[3] In the interests of brevity, and as it raises rather different issues, I do not address the judge's response to a further ground related to the directors' response to the order made by the Hague District Court (the "Dutch Court") on 26 May 2021 in *Milieudefensie v Royal Dutch Shell plc* ECLI:NL:RBDHA:2021:5339.

But, it was said, they had failed to put in place policies reasonably capable of achieving those objectives. In legal terms, the ETS could be taken as an indication of their view (under section 172) of the strategy "most likely to promote the success of the company for the benefit of its members as a whole", having regard (inter alia) to the "likely consequences of any decision in the long term" and the "impact of the company's operations on the community and the environment".
That having been decided, it fell to the directors to then determine appropriate measures and policies reasonably capable of achieving the goals they had set. This, it was said, they had failed to do, in breach of their duties of "reasonable care, skill and diligence" under section 174.

However, as the judge recognised (para 39ff), there were some very specific points in the pleadings. A central criticism related to Shell's failure to set credible reduction targets in respect of Scope 3 emissions – that is, the indirect emissions that arise when Shell's products are used by its customers – as opposed to Scope 1 (direct emissions from the production of oil and gas) and Scope 2 (indirect emissions from the energy used to carry out its operations, such as refining).
Mr Benson had explained that international standards on corporate transition plans generally require a company's targets to include a reduction in Scope 3 emissions, which in practice represented the "vast majority" of its emissions (JT para 42). As the judge noted:

> "50. The core of the criticism on which the allegations of breach of duty made in paragraphs 51 and 52 of the particulars of claim is based is what is said to be the inadequacy of the targets for Shell's Scope 1, 2 and 3 emissions as disclosed in the April 2022 report. All three have a 100% target for 2050, but ClientEarth relies on the fact that there is no pathway for the Scope 3 absolute emissions and that the pathway for the Scope 1 and 2 targets relating to absolute emissions is 50% by 2030 and 20% for the carbon intensity of the products it sells."

In short, Shell had set 100% targets for reduction of all emissions (Scope 1, 2 and 3) by 2050, and interim pathways (including absolute 2030 targets) for Scope 1 and 2 emissions, but no equivalent pathway for the "vast majority" of its emissions (Scope 3).

Another specific criticism related to the directors' proposals to make significant new investments in fossil fuel projects:

> "It is said that Shell intends only a modest decline in its oil production and an active growth in its gas business, in the case of liquified natural gas by creating new markets and embracing new customers. Details are given of 27 projects which are described as significant oil and gas assets under construction, said to hold 2.48 billion barrels of oil and which are said to be estimated to be producing oil and gas for decades to come." (para 52)

These plans were said to "run directly contrary to the directors' assertions that Shell is preparing for the transition to a Paris Agreement-aligned economy and its own NZ target..." (para 53).

The judge did not find it necessary to address these points in any detail. Nor is it clear from the judgment what, if any, response was made by Shell in its submissions. He in effect dismissed Mr Benson's evidence out of hand because "neither he nor ClientEarth is able to give expert evidence on which the court can properly rely" (para 59).

Apart from Mr Benson's acknowledged lack of specific expertise, he gave in substance two reasons. First, in the absence of any "universally accepted methodology" for achieving the ETS reductions, there was no proper basis for alleging that "no reasonable board of directors could properly conclude that the pathway to achievement is the one they have adopted" (para 64).

Secondly, ClientEarth's submission missed the "fundamental point" that the directors' duties required them to take into account:

> "...a whole range of considerations in the management of Shell's business towards promoting its success for the benefit of its members as a whole, and not just their response to the risks posed by climate change...
>
> ...it only concentrates on one aspect of their decision making. There is no recognition of the directors' obligation to balance the significance of that feature against the many other competing commercial considerations with which the law permits and indeed requires them to be concerned." (paras 65–7)

The judge went on to hold that in any event the relief sought by ClientEarth was not appropriate. A mandatory injunction requiring Shell to adopt and implement a strategy to manage climate risk in compliance with its statutory duties would be too imprecise to be suitable for enforcement (para 82). Declaratory relief would serve no legitimate purpose:

> "In any proceedings, the court is concerned with the utility of the substantive relief sought. It is not the court's function to express views as to the directors' conduct which have no substantive effect and which fulfil no legally relevant purpose. The proper forum for generating those types of view as to the directors' conduct is by vote of the members in general meeting, a remedy which ClientEarth is entitled to take steps to procure in its capacity as a shareholder." (para 83)

Finally, the judge determined that ClientEarth had failed to show that its proceedings were brought in "good faith" as required by the section. He applied what he called a "but for" test:

> "This test was applied in a pre-CA 2006 case (per Peter Gibson LJ in *Barrett v Duckett* [1995] BCC 362, 367H-368D) and was adopted in Iesini[4] at [113] to [121] (albeit with the opposite result), in which Lewison J held that, because the dominant purpose of the claim was to benefit the company, it could not be said that, but for the collateral purpose, the claim would not have been brought at all. For that reason the claim in Iesini was brought in good faith." (para 89)

Applying this approach to the present case, he said:

> "It... seems to me that, where the primary purpose of bringing the claim is an ulterior motive in the form of advancing ClientEarth's own policy agenda with the consequence that, but for that purpose, the claim would not have been brought at all, it will not have been brought in good faith. The reason for this is that it will be clear to ClientEarth that it is using an exceptional procedure in the form of a derivative action, for a purpose other than the purpose for which the legislation has made it available." (para 92)

The fact that ClientEarth as the holder of only 27 shares in Shell was seeking relief on behalf of Shell in a claim "of very considerable size, complexity and importance (and [which] will be exceptionally expensive and time consuming to pursue)" gave rise, in the judge's view, to a clear inference that its real interest is "not how best to promote the success of Shell for the benefit of its members as a whole". Rather, the judge considered that ClientEarth had adopted a "single-minded focus on the imposition of its views and those of its supporters as to the right strategy for dealing with climate change risk" (para 93).

[4] *Iesini & Ors v Westrip Holdings Ltd & Ors* [2009] EWHC 2526 (Ch).

In a separate lengthy judgment (running to 34 paragraphs – [2023] EWHC 2182 (Ch)), the judge made an order for costs in favour of Shell, as a departure from the normal rule that there should be no order for costs at that stage. He justified this departure for a number of reasons (paras 27–31). In summary, the adverse publicity likely to result for Shell, such that the "mere finding of a prima facie case would have an unusually significant adverse impact on the conduct of its affairs"; the wide-ranging nature of the attack on Shell's strategy "looking to the future rather than specific acts of corporate wrongdoing causing measurable loss"; the small number of shares held by ClientEarth; the fact that a full-blown application for permission would be "unusually expensive and resource intensive", so that Shell's attendance at the hearing was a "proportionate response"; and the likelihood that the court would have invited Shell's attendance even if Shell had not volunteered its participation (under CPR PD 19A para 2).

An application for permission to appeal both judgments was dismissed by a single Lord Justice on the papers on 14 November 2023. Under the current rules, that is the end of the matter as far as this case is concerned.

Commentary

With respect to the judge, I find his reasons for dismissing this case at the preliminary stage unpersuasive on all these points.

On the legal aspects, it is perhaps unfortunate that the court seems to have been drawn into a lengthy discussion (paras 20–37) of the relationship of the various duties under ss 170ff, including a discussion of the incidental duties said to arise, and the possible overlap between issues of rationality and good faith. This may have diverted attention from what was in effect common ground. There was no dispute that the directors had in good faith made a valid exercise of judgment under s 172 to adopt the ETS; nor that it was for them in the first instance to determine policies and measures appropriate to achieve that objective. But equally, Shell accepted that, for the purpose of s 174, its decisions in that respect must not "fall outside the range of decisions reasonably available to the directors at the time" (JT para 32, citing *Sharp v Blank* [2019] EWHC(Ch) 3096 [631]). ClientEarth's case, in short, was that the directors had failed that test.

Turning to the facts, the judge's summary dismissal of Mr Benson's evidence seems most surprising. The essential issues here were not technical issues dependent on expert evidence, but related to the directors' decision making. Had this been a judicial review proceeding against, for example, a local authority, it would have been commonplace for the necessary factual material, relating to the authority's decisions and their background, to be assembled in the form of a witness statement from a lawyer for the applicant. No one would have suggested that "expert" evidence was needed. It is also unclear what particular "expertise" the judge thought to be in play. Although Shell was represented at the hearing, there is no indication that it was challenging the accuracy of Mr Benson's factual account, as such. At this stage, the only issue was whether a 'prima facie' case had been shown. No doubt, if some difference on a particular technical issue requiring expert evidence had emerged, appropriate direction could have been given.

His two substantive reasons are equally unconvincing. The observation that there was no "universally accepted methodology" for achieving the ETS reductions does not begin to answer the case that the directors had failed to adopt any credible methodology. Equally, it is difficult to understand the relevance of his "fundamental point" that the directors' duties required them to "balance" the issue of climate change against the "many other competing commercial considerations with which the law permits and indeed requires them to be concerned". ClientEarth's case was that the directors had already drawn that balance in adopting the ETS.

The issue was whether they had any credible policies for achieving it. The judgment fails entirely to address that point. It is not even apparent from the judgment what, if any, policies were relied upon by Shell in its own submission.

The judge's observations on the possible remedies were strictly unnecessary, given his decision on the substance. I can understand his view that a mandatory injunction would be inappropriate, being difficult to draft and impracticable to enforce. However, it is hard to understand his objections to a declaratory remedy. A declaration that the Shell Board was in breach of its legal duties under section 174 in failing to adopt credible polices to achieve its own climate change strategy would surely have had a very powerful effect. In practice, the Board would have felt bound to take steps to legitimise its position. It is no different in substance from the effect of a declaration of illegality against a public authority. It would be very surprising for such a remedy to be refused because of its lack of direct coercive effect. The public authority is expected to comply.

I also find it difficult to understand his decision that the proceedings were not brought in "good faith". In a sense, any shareholder taking such action has an 'ulterior purpose', if only the desire to protect the value of their own shareholding. Their interests and those of the company coincide. No doubt, ClientEarth was motivated by its own "policy agenda" (which happened also to reflect UK government policy), but for which it would probably not have started the proceedings. But the direct purpose of the proceedings was to benefit the company, by implementing the strategy that the directors had themselves determined to be in its long-term interests. As in Iesini (para 121), the "dominant purpose" of the proceedings was related to the interests of the company, which coincided with those of ClientEarth.

Finally, the judge's decision on costs seems to create an unfortunate precedent, if only by the uncertainty it generates for future litigants. This at least would surely have merited consideration by the Court of Appeal. The points made by the judge as to the importance and complexity of the case were no doubt good reasons why, if Shell had made an application to be joined as a party at the application stage, it would have been allowed. But, in that event, the issue of costs could have been addressed, and ClientEarth could have sought some protection. In the absence of such an application, it is difficult to see why such points should have been regarded as justifying a departure from the norm.

Conclusion

Lord Sales, Justice of the Supreme Court, speaking extra-judicially in 2019, said:

> "As things stand, there is much force in the view that directors may and increasingly must take into account and accord significant weight to climate change in their decision making [...] Under certain circumstances, however, their companies' interests may be so implicated by climate change effects that their general fiduciary and due care obligations actually require them to cause their companies to take action to reduce their contribution to climate changing activity."[5]

It is difficult to think of a company whose interests are more "implicated by climate change effects" than a major fossil fuel operator such as Shell. The challenge by ClientEarth to the climate change policies adopted by its Board could have been a valuable chance to examine the operation of the relevant Companies Act provisions, both in general and in the particular context of the fiduciary and due care obligations referred to by Lord Sales. I find it surprising that the judge held that ClientEarth had failed to disclose even a prima facie case, and unfortunate that the application for permission to appeal was dismissed by a single Lord Justice without any form of hearing. It was a missed opportunity.

Lord Robert Carnwath, February 2024

[5] Lord Sales, *directors' duties and climate change: keeping pace with environmental challenges* (27 August 2019 Anglo-Australasian Law Society, Sydney). See www.supremecourt.uk/docs/speech-190827.pdf.