The ClientEarth Claim Against the Board of Shell

A sign of things to come in the UK?

The commencement of a shareholder derivative claim[1] (the first of its kind in the UK) against the board members of Shell for allegedly failing to manage the material and foreseeable risks posed to the company by climate change has understandably garnered a lot of attention. Although ClientEarth has formidable hurdles to overcome if it is to pursue the claim given a preliminary decision of the English High Court on 12 May 2023 to refuse permission for the proceedings to go forward, it has arguably already scored a public relations victory for its cause.

TIMING AND CONTEXT

According to its press release, ClientEarth first wrote to the board of Shell in March 2022 notifying it of this potential claim. This was the same month in which Shell lodged an appeal against a May 2021 decision of the Hague District Court. In that case, the court had ruled that under an unwritten duty of care in Dutch tort law, Shell has an "*obligation of result*" to reduce CO_2 emissions resulting from Shell group's activities, and a "*best-efforts obligation*" to reduce emissions generated by its business relations, including suppliers and end-users. Although this case was brought not by ClientEarth but by Friends of the Earth Netherlands on behalf of a group of residents in the low lying Wadden Sea area, and although it was against the company rather than its directors, the timing and outcome of Shell's appeal in the Dutch case are likely to be significant. Indeed, it is possible that the two pressure groups are coordinating their tactics.

The two cases share the common theme that, according to a "*widely endorsed consensus*" (in the words of the Dutch court), agreed at the 2015 Paris Treaty on climate change, emissions must be reduced by net 45% by 2030 and to net zero by 2050. Significantly, the Dutch Court held that this consensus applied globally, including to non-state actors and that, on that basis, Shell was expected to do its part to achieve these so-called "*reduction pathways*" This decision marked the first time any court in the world had imposed a duty on a company to do its share to prevent dangerous climate change. Building on this finding, ClientEarth now alleges in its derivative claim that Shell's strategy is not Paris Treaty aligned and that Shell continues to over-invest in new fossil fuel projects, creating the twin risk for the company of stranded assets and of increasing disinvestment from the shareholder community. ClientEarth seeks a court order compelling the board to require the company to take action.

THRESHOLD CHALLENGE FACED BY CLIENTEARTH

ClientEarth needed to persuade the English High Court that, in the face of a reported $41.6 billion profit in 2022, Shell's strategy, as dictated by its board, was nevertheless flawed and that such flaws were due to breaches of duty by its directors.

Under section 172 of the UK Companies Act, directors are under an obligation to promote the success of the company having regard to the following specific factors:

(a) the likely consequences of any decision in the long term;
(b) the interests of the company's employees;
(c) the need to foster the company's business relationships with suppliers, customers and others;
(d) the impact of the company's operations on the community and the environment;
(e) the desirability of the company maintaining a reputation for high standards of business conduct; and
(f) the need to act fairly as between members of the company.

Against the background of the climate emergency but allowing for the renewed geopolitical focus on energy security, taking business decisions which fulfil all these requirements, whilst continuing to promote the success of the company, is obviously challenging.

Section 172 of the Companies Act has been the subject of regulatory and shareholder criticism as a toothless tiger. This is because the legal duty on directors is limited to *promoting the success of the company* whilst only requiring directors to have regard to the six factors listed above. There is a small but significant distinction between requiring board members to have regard to a list of factors and requiring them to take account of them. Indeed, there is a campaign to amend section 172 to require directors to take decisions which *advance the company's purpose* whilst *requiring* them to *take account of* the six factors listed above (including the environment).

It is true that there is guidance[2] to the effect that in discharging their section 172 duties, directors cannot simply claim to have relied on professional advice. But it was always going to be a big stretch for ClientEarth to persuade a court that there has been a breach of section 172. Were this to be the relevant threshold, ClientEarth's prospects of ultimate success would be better.

THE PRELIMINARY PERMISSION STAGE IN THE PROCESS

Section 261 of the Companies Act requires an applicant for a derivative claim (i.e. a claim in which the company is permitted by the court to become the claimant against its own board of directors as defendants) first to establish a *prima facie* case. This important procedural step is designed to avoid cases of abuse. It is done on paper without the parties being present and is based on witness statement evidence from the applicant as to the alleged defaults or breaches of duty by the directors on which the action is founded. Only if the Court is persuaded that the case has merit will the application proceed to a full permission hearing with the involvement of the company.

It was this preliminary permission stage which was adjudicated on by the Court on 12 May 2023. Mr Justice Trower had no difficulty concluding that ClientEarth had not established a *prima facie* case. He did so on a variety of alternative grounds, reaffirming the general principle that "*the law respects the autonomy of the decision making of the Directors on commercial issues and their judgments as to how best to achieve*

results which are in the best interests of their members as a whole".

He was unimpressed with ClientEarth's evidence of alleged breaches of duty by the directors of Shell, concluding that:

> "The evidence does not engage with the issue of how the Directors are said to have gone so wrong in their balancing and weighing of the many factors which should go into their consideration of how to deal with climate risk, amongst the many other risks to which Shell's business will inevitably be exposed, that no reasonable director could properly have adopted the approach that they have. This is a fundamental defect in ClientEarth's case because it completely ignores the fact that the management of a business of the size and complexity of that of Shell will require the Directors to take into account a range of competing considerations, the proper balancing of which is classic management decision with which the court is ill-equipped to interfere."

The judge also looked at the remedies sought by ClientEarth and was unconvinced that they were suitable for enforcement. Finally, although not strictly necessary for his judgment, he also considered the areas in which the court would be able to exercise its discretion in deciding whether to allow the matter to proceed beyond the preliminary stage to a full hearing. Among these is whether ClientEarth was acting in good faith. Here the judge accepted Shell's inference that it was seeking to pursue its own policy agenda in a public forum rather than seeking to advance the interests of Shell. The fact that ClientEarth owned just 27 shares in Shell (and even adding in the shareholders who were thought to support its position on climate change, this still accounted for only in the region of 0.17% of shareholders) also influenced the judge when set against some 80% of shareholders who were believed to support the board's stance.

Despite the robust nature of the Judge's conclusions, ClientEarth is thought to have chosen to seek a full oral hearing of the issues adjudicated on. No doubt this will allow it the opportunity to attract more attention to the issue of climate change (albeit by incurring considerable additional legal expenses). Were it to succeed (which seems unlikely), the court would order the directors to be respondents to the permission application and would give directions for a substantive hearing.

RELEVANT DIRECTORS & OFFICERS LIABILITY INSURANCE CONSIDERATIONS

D&O policies are often lengthy and complex contracts. They can contain a variety of potential coverage pitfalls both in respect of derivative claims in general and cases involving climate change in particular. Some of the more important ones are listed below:

- **How is a derivative claim defined and treated?**

  The majority of D&O policies include derivative claims within the definition of "*Securities Claims*". The logic is that this type of claim is initiated by holders of securities, i.e. shares in the company.[3] A consequence of this is that the self-insured retention applicable to the claim is often much higher than it would be for other types of claim brought against directors including by the company itself.

- **How is the defence and settlement of a derivative claim funded?**

  In the extremely rare event (at least in a listed company context) of a judgment being delivered ordering directors to compensate the company,[4] it cannot itself fund such a settlement otherwise the money would be going round in a circle. That same logic applies to derivative lawsuits brought in the US where such

claims are much more commonplace. So, it is only the D&O insurers or the directors themselves who could fund such a judgment (or more likely a settlement).[5] That still leaves open the question of the funding of the defence of the derivative claim. There is no reason in principle why a company should not be permitted to fund the defence of the derivative claim both against itself and its directors until such time as either the court directs that the claim should be allowed to proceed to a full hearing or the independent special investigation committee recommends (or the shareholders demand) that the action should be adopted by the company.[6]

- **Derivative investigation costs extensions and coverage**

Many policies for listed companies provide a specific extension for the costs incurred by the company in setting up and administering a special committee to investigate whether the action should be pursued against the directors or not (see above). Whether this extension (which is always sub-limited) is something which the directors would care about in coverage terms is questionable since these costs are only entity costs.

The more important question for directors is whether their own legal representation costs, in dealing with requests for evidence and information from a special investigation committee, would also be covered under the policy and, if so, under what terms and subject to what limits or restrictions.

- **Bodily injury, property damage and death exclusion**

  This type of exclusion is also almost invariably found in D&O policies. Most good policies carve out (i.e. remove from the ambit of the exclusion) defence costs incurred in this type of claim thus providing directors with a key measure of protection, but there are pitfalls here. One of the most common is that the carve out often does not extend to costs incurred in dealing with investigations as opposed to actual claims – since investigations into the effects of climate change on human health and on property in the context of a company's action or inaction can be extremely costly.

A further pitfall with this type of exclusion is that it can be expressed to capture any claim or loss "*directly or indirectly arising from or relating to*" bodily injury and death exclusion. That can have the result that claims with only a tangential or partial connection to this form of loss are excluded.

- **The definition of "Pollutants"**

The definition of "Pollutants" varies from policy to policy and is often used within the definition of "Loss" to restrict cover on the basis that "Loss" under the policy as defined does not extend to any clean-up costs for pollutants. In 2007, the US Supreme Court in *Massachusetts v Environmental Protection Agency* ruled that carbon dioxide was itself a pollutant. Depending on the language used in the policy and the type of claim asserted, this too could have unwelcome coverage implications.

CONCLUSION

Whatever the outcome of the UK derivative claim against Shell and the linked appeal by Shell in the Dutch case discussed above, the overwhelming likelihood is that there will be more claims brought against large publicly listed companies and adopting these and other novel case theories. The obvious public relations and publicity advantages of being able to link such claims to individual board members (notwithstanding the legal obstacles) make main board directors more of a target for such claims than perhaps ever before. A thorough understanding of the protections available to these individuals, not least under the directors and officers liability insurance policies purchased on their behalf, is to be recommended.

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The original version of this paper was first published in February 2023 by the Chartered Governance Institute UK & Ireland. It has since been updated.

NOTES

[1] A shareholder derivative claim under the UK Companies Act allows shareholders (with court approval) to bring a claim against the directors on behalf of the company in circumstances where a company is unwilling to pursue such a claim itself.

[2] The relevant guidance comes in the form of a Government consultation paper issued in 2018 by the Insolvency Service which warned against over-reliance on professional advice in these terms:

> *"Many companies, particularly larger and more complex ones, will often seek professional advice, for example on financial, legal or competition matters, so that directors have access to the expertise needed to help them make important decisions for the company. Indeed, in some cases they will be required to do so. It is important to recognise, however that the duties and responsibilities of directors to the company are different from those of professional advisers. Directors are subject to the duty under section 172 of the Companies Act, as well as duties to exercise independent judgement and to exercise reasonable care, skill and diligence. Professional advisers, on the other hand are subject to whatever legislation, standards or supervision applies to their particular profession and contractual obligations to their client."*

The board of Shell will no doubt have had this guidance in mind while performing the delicate balancing act between the need to have regard to factors including the environment, while continuing to discharge its statutory obligations.

[3] Although as we have seen, they are in pursued on behalf of the company rather than its shareholders.

[4] ClientEarth is not even seeking this form of relief from the court in its case against Shell.

[5] Indeed, some very large companies choose only to buy D&O insurance for this specific risk (coupled with the risk of insolvency where the company obviously cannot pay for any judgment, settlement or defence costs).

[6] Whether insurers always allow for this ability in pricing a company's exposure to derivative claims is debateable.

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