Message in a *Harbottle*: Reassurance for UK Boards Facing Litigious Activists

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Introduction

SR1[1] Shareholder activism appears to be on the rise, with Europe, including the United Kingdom, gaining 'market share' from the United States.[1] One driver, and challenge for boards, is the heightened focus in recent years on environmental, social and governance (ESG) considerations.

Litigation typically plays a small part in UK activist campaigns. It is more common in the public law arena, where judicial review proceedings have attempted, for example, to halt fossil fuels projects or to cause the UK government to reconsider its net zero strategy.[2]

This said, the UK activist's toolkit includes the derivative claim, either under the Companies Act 2006 (the 'Act') or at common law. In a derivative claim, interested parties can step into a company's shoes to seek to right wrongs suffered by the company at the hands of the company's directors – after all, the board of the company is unlikely to sue its constituent members. These claims are typically brought by minority shareholders against a company's directors.

A recent case, decided in 2023, has thrust the derivative claim into the spotlight: *ClientEarth v Shell plc*.[3] As we have set out below, however, this case shows that derivative claims are unlikely to secure changes in the operating policies of companies and are likely to leave the derivative claim as one of the less utilised tools in the activist's toolkit.

McGaughey v Universities Superannuation Scheme Limited,[4] also decided in 2023, found that participants in a pension scheme could not bring a derivative claim against the directors of the scheme's corporate trustee. Although not as significant as *ClientEarth*, this case seems to put another nail in the coffin of the derivative claim as a tool for activists, and it has potentially sealed off one way in which participants could challenge funds' investment strategies (and, indirectly, the operating policies of investee companies).

This article outlines the history of the derivative claim. It then reviews *ClientEarth* and briefly considers *McGaughey*, which involved the

claim's statutory and common law versions respectively. It concludes by assessing the significance of these cases for activism in the UK going forwards.

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1 *Shareholder Activism Update: Early Look at 2023 Trends* (Lazard, 18 April 2023).
2 See, eg, *R (on the application of ClientEarth) v Secretary of State for Business, Energy and Industrial Strategy* [2021] EWCA Civ 43, [2021] All ER (D) 07 (Feb) and *R (Friends of the Earth Ltd) v Secretary of State for Business, Energy and Industrial Strategy* [2022] EWHC 1841 (Admin), [2023] 1 WLR 225.
3 [2023] EWHC 1897 (Ch).
4 [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319.

A (Brief) History of the Derivative Claim

SR1[2] What does contemporary shareholder activism have to do with a case decided in the mid-19th century? *Foss v Harbottle* (and many cases that followed it since) established what have become known as the 'proper plaintiff' and 'majority rule' principles.[1] Respectively:

(1) the proper claimant in respect of a wrong alleged to be done to a company is, prima facie, the company itself; and
(2) if the alleged wrong can be confirmed or ratified by a majority of members in general meeting, the courts will not interfere.

Together these are known as the rule in *Foss v Harbottle*; and it has acted as a high hurdle to overcome for shareholders, including activists, bringing claims.

In the subsequent century there emerged four exceptions to the rule. As summarised by the High Court in 1978 and cited approvingly by the Court of Appeal in 2003:

> 'The exceptions are four in number . . . . The first exception is that a shareholder can sue in respect of some attack on his individual rights as a shareholder; secondly, he can sue if the company, for example, is purporting to do by ordinary resolution that which its own constitution requires to be done by special resolution; thirdly, if the company has done or proposes to do something which is ultra vires; and fourthly, if there is fraud and there is no other remedy. There must be a minority who are prevented from remedying the fraud or taking any proceedings because of the protection given to the fraudulent shareholders or directors by virtue of their majority.'[2]

Where a case falls within the fourth exception to the rule, the courts have allowed the minority to bring a claim in the name of the company (as the wrongdoer in control would be very unlikely to cause the company to bring a claim). This is the basis of the common law derivative claim. As noted in *McGaughey*, the 'rationale for the derivative action is to enable justice to be done where the wrongdoer is in control of the entity in which the cause of action is vested'.[3]

In the mid-1990s, the Law Commission carried out a review of shareholder remedies, including the rule in *Foss v Harbottle* and its exceptions. In its view:

> ' . . . the law relating to these exceptions is rigid, old fashioned and unclear . . . inaccessible save to lawyers specialising in this field because, to obtain a proper understanding of it, it is necessary to examine numerous reported cases decided over a period of 150 years.'[4]

The result of that Law Commission review was the enactment of a statutory derivative claim in Part 11 of the Act. Concurrently, Chapter 2 of Part 10 of the Act placed directors' duties on a statutory footing. These two developments interacted with each other. A statutory derivative claim can be brought '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'.[5] This represented a significant broadening of the basis of a derivative claim compared to the fourth exception to the rule in *Foss v Harbottle*. Unlike under *Foss v Harbottle*, under the statutory procedure there is no need to evidence fraud and wrongdoer control to be able to bring a derivative claim.

As the Act progressed through Parliament, concerns were raised that the new, statutory derivative claim would facilitate claims by 'activist shareholders' against directors:

> 'The range of circumstances under which a derivative action may be brought will be much wider than is currently the case . . . The codification of the basis of bringing a claim and the means of bringing that claim will serve only to make it easier for claims to be brought against company directors . . .
>
> The concern that part 11 will increase potential liabilities for directors and the chance of tactical and vexatious litigation by activist shareholders has been raised by many others . . . '[6]

Although, in the authors' view, the introduction of the statutory derivation action did not open the floodgates of litigation, *ClientEarth* is exactly the sort of case about which warnings were aired. ClientEarth, an organisation that is not a 'normal' financial investor, but rather has a mission to 'use the power of law to bring about systemic change that protects the earth for – and with – its inhabitants', centred its claim on alleged breaches by Shell's directors of their statutory duties.

One question that, for a time, remained open following the introduction of the statutory claim was the extent to which it superseded the common law version. Subsequent cases have shown that the statutory claim has abolished the common law claim in relation to so-called single derivative actions, where a shareholder of a company incorporated under the Act claims in respect of a cause of action vested in the company. However, the common law survives for so-called multiple derivative actions, where a shareholder of a holding company brings a claim in respect of a cause of action vested in a direct or indirect subsidiary.[7] It also survives in respect of overseas companies and bodies corporate other than companies (eg LLPs and trade unions).[8] *McGaughey* was formulated as a common law, multiple derivative claim.

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1 (1843) 2 Hare 461, 67 ER 189.

2 *Daniels v Daniels* [1978] Ch 406, [1978] 2 All ER 89; *Harris v Microfusion 2003-2 LLP* [2016] EWCA Civ 1212, [2017] All ER (D) 32 (Jan).

3 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [64].

[4] *Shareholder Remedies Report*, LC246, 24 October 1997, p 2.
[5] Companies Act 2006, s 260(3).
[6] HC Deb 17 October 2006, vol 450, cols 825 and 826.
[7] *Universal Project Management Services Ltd v Fort Gilkicker Ltd* [2013] EWHC 348 (Ch), [2013] All ER (D) 313 (Feb); *Boston Trust Company Ltd v Verhoef* [2021] EWCA Civ 1176, [2022] 1 All ER (Comm) 1013.
[8] See, eg, *Harris v Microfusion 2003-2 LLP* [2016] EWCA Civ 1212, [2017] All ER (D) 32 (Jan).

ClientEarth v Shell plc

SR1[3] On 9 February 2023, ClientEarth, a non-profit environmental law organisation that held 27 shares in Shell plc (a company that had more than seven billion shares in issue as at 31 December 2022), applied for permission in the High Court to continue a statutory derivative claim against Shell's directors. ClientEarth claimed that Shell's directors had breached their statutory duties to promote the success of the company and to exercise reasonable care, skill and diligence (owed under ss 172 and 174 of the Act respectively). These purported breaches were said to arise from acts and omissions relating to Shell's climate risk management strategy. ClientEarth also alleged that the directors had breached a further, non-statutory duty to take reasonable steps to ensure a court order was obeyed. This purported breach of duty was said to arise out of a failure to comply with an order made by the Hague District Court on 26 May 2021, which required Shell to limit its CO_2 emissions by at least net 45 per cent by 2030, relative to 2019 levels (the 'Dutch order').[1]

ClientEarth sought:

(1) a declaration that Shell's directors had breached their duties in the manner alleged; and
(2) a mandatory injunction requiring Shell's directors to adopt and implement a strategy to manage climate risk in compliance with their statutory duties and to comply immediately with the Dutch order.

In a judgment informed by written submissions made by ClientEarth and Shell and handed down by Trower J on 12 May 2023, ClientEarth was denied permission to continue the claim.[2] As was its right, ClientEarth requested, and was granted, an oral hearing to ask the High Court to reconsider its decision. The hearing took place on 12 July. On 24 July, Trower J handed down a judgment dismissing the claim.[3] On 31 August 2023, Trower J handed down a further judgment ordering ClientEarth to pay Shell's costs while refusing permission to appeal.[4]

This case represented only the first step in bringing a statutory derivative claim. At this stage of the claim, ClientEarth had to make out a prima facie case for it to be able to continue the claim. If it had succeeded, it would then have been able to step into Shell's shoes to claim against the directors for breach of their duties at a full trial.

As to whether or not Shell's directors breached duties owed under ss 172 and 174 of the Act, the court held that ClientEarth had failed to make this

out. ClientEarth postulated that ss 172 and 174 gave rise, in the context, to six necessary incidents of those duties, namely:

> 'i) a duty to make judgments regarding climate risk that are based upon a reasonable consensus of scientific opinion;
> ii) a duty to accord appropriate weight to climate risk;
> iii) 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];
> iv) a duty to adopt strategies which are reasonably likely to meet Shell's targets to mitigate climate risk;
> v) a duty to ensure that the strategies adopted to manage climate risk are reasonably in the control of both existing and future directors; and
> vi) a duty to ensure that Shell takes reasonable steps to comply with applicable legal obligations.'[5]

Rejecting this submission, Trower J held, in respect of s 172, that the incidental duties' formulation 'is inconsistent with the well-established principle that it is for directors themselves to determine (acting in good faith) how best to promote the success of a company for the benefit of its members as a whole'.[6] 'It is well established that the test for breach of s.172 is a subjective one . . . and requires proof of conduct other than in good faith.'[7] In respect of s 174, he held that 'not only does the law not superimpose on that duty more specific obligations as to what is and is not reasonable in every circumstance, it also requires the Directors to continue to manage Shell's business with an open mind and to continue to have regard to a range of competing considerations'.[8]

In reaching these conclusions, Trower J cited approvingly Lewison J in *Iesini v Westrip Holdings Limited*:[9] 'The weighing of all these considerations [as set out in s 172] is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case.'[10] He also cited Lord Wilberforce in *Howard Smith Ltd v Ampol Ltd*:[11] 'There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.'[12] The judgment is a reminder of the courts' deference to corporate decision-making, which stretches back to *Harbottle*.

On the facts, Trower J held that there was no evidential basis for alleging that no reasonable director could have adopted the approach to mitigating climate risks taken by Shell's board, and that ClientEarth's case ignored the need for Shell's directors, in managing the company's affairs, to balance a range of competing considerations.[13]

As regards the purported 'non-statutory' duty requiring compliance with the Dutch order, Trower J held that 'there is no established English law duty separate or distinct from the general duties owed by the Directors to Shell under [the Act], which requires them to take reasonable steps to ensure that the order of a foreign court is obeyed, let alone to ensure compliance with that order'.[14] While the desirability of the company maintaining a reputation for high standards of business conduct is one of the factors to which the directors must have regard when acting in

furtherance of s 172 of the Act (by virtue of s 172(1)(e)), the evidence did not 'come close to establishing a prima facie case that the Directors have no genuine intention of procuring Shell to comply with . . . the Dutch Order'.[15]

Having dispensed with the alleged breaches, Trower J turned to the prospects of the court granting the relief sought were the proceedings continued beyond the prima facie stage. He held that 'the nature of the relief sought is as much a factor in the company's entitlement to obtain that relief as is the nature of the breaches on which ClientEarth relies'.[16]

Citing *Co-operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd*,[17] Trower J held that the court will not grant a mandatory injunction if constant supervision by the court is required.[18] Indeed, he found it was difficult to see how 'the disruptive impact which disputes over compliance would have on the conduct of Shell's business would not of itself have the serious adverse impact on the success of Shell for the benefit of its members as a whole, which ClientEarth contends that these proceedings are designed to avoid'.[19]

Concerning declaratory relief, Trower J held that 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'.[20] Rather, he considered the 'proper forum' for the expression of such views to be 'by vote of the members in general meeting', which ClientEarth was 'entitled to take steps to procure in its capacity as a shareholder'.[21]

Finally, Trower J turned to the discretionary factors to be taken into account under s 263(3) of the Act when considering whether to give permission to continue a derivative claim. His judgment addressed in particular whether ClientEarth acted in good faith in bringing the claim. He considered ClientEarth's small shareholding of merely 27 shares gave rise to a very clear inference that ClientEarth's real interest in pursuing the claim was not how best to promote the success of Shell for the benefit of its members as a whole, but rather to impose on Shell its views, and those of its (non-shareholder) supporters, as to the right strategy to deal with climate change.[22]

As a derogation from the general rule that the loser in litigation pays the winner's costs, at the prima facie stage of a derivative claim the company will 'normally' be unable to recover the costs of any submission or attendance made without invitation from the court.[23] Despite this, Shell sought an order that ClientEarth pay all its costs, on several grounds. In summary these were:

(1) the seriousness of the allegations against Shell's directors;
(2) the likelihood that the claim would generate substantial media attention adverse to Shell;
(3) ClientEarth's failure to substantively engage with the arguments presented by Shell in its response to ClientEarth's letter before claim;
(4) the absence of good faith; and
(5) the claim's lack of merit and ClientEarth's failure to adhere to basic procedural requirements, such as properly providing expert evidence.[24]

Trower J substantially agreed with these submissions and granted a costs order in favour of Shell. He found that the case was 'far from the norm for many reasons' and that Shell attending the hearing and making written submissions was an 'appropriate and proportionate' response.[25]

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1 *Milieudefensie v Royal Dutch Shell* (2021), ECLI:NL:RBDHA:2021:5339.
2 *ClientEarth v Shell plc* [2023] EWHC 1137 (Ch), [2023] All ER (D) 65 (May).
3 *ClientEarth v Shell plc* [2023] EWHC 1897 (Ch).
4 *ClientEarth v Shell plc* [2023] EWHC 2182 (Ch), [2023] All ER (D) 05 (Sep).
5 *ClientEarth* [2023] EWHC 1897 (Ch) at [22].
6 *ClientEarth* [2023] EWHC 1897 (Ch) at [28].
7 *ClientEarth* [2023] EWHC 1897 (Ch) at [29].
8 *ClientEarth* [2023] EWHC 1897 (Ch) at [31].
9 [2009] EWHC 2526 (Ch), [2011] 1 BCLC 498, [2010] BCC 420.
10 [2009] EWHC 2526 (Ch), [2011] 1 BCLC 498, [2010] BCC 420 at [85].
11 [1974] AC 821, [1974] 1 All ER 1126.
12 [1974] AC 821, [1974] 1 All ER 1126 at 1131H.
13 *ClientEarth* [2023] EWHC 1897 (Ch) at [66].
14 *ClientEarth* [2023] EWHC 1897 (Ch) at [36].
15 *ClientEarth* [2023] EWHC 1897 (Ch) at [78].
16 *ClientEarth* [2023] EWHC 1897 (Ch) at [79].
17 [1997] UKHL 17, [1998] AC 1, [1997] 3 All ER 297.
18 [1997] UKHL 17, [1998] AC 1, [1997] 3 All ER 297 at 302G–H.
19 *ClientEarth* [2023] EWHC 1897 (Ch) at [81].
20 *ClientEarth* [2023] EWHC 1897 (Ch) at [83].
21 *ClientEarth* [2023] EWHC 1897 (Ch) at [83].
22 *ClientEarth* [2023] EWHC 1897 (Ch) at [93].
23 19A PD 2.
24 *ClientEarth* [2023] EWHC 2182 (Ch), [2023] All ER (D) 05 (Sep) at [10]–[13].
25 *ClientEarth* [2023] EWHC 2182 (Ch), [2023] All ER (D) 05 (Sep) at [27] and [33].

McGaughey v Universities Superannuation Scheme Limited

SR1[4] In October 2021, Dr McGaughey and Professor Davies, two participants in the Universities Superannuation Scheme (the 'Scheme'), filed an application to continue a common law, multiple derivative claim in the High Court. The claimants sought permission to bring a claim on behalf of the Universities Superannuation Scheme Ltd (USSL), the Scheme's corporate trustee and administrator, against USSL's directors. Although a number of breaches were alleged, the essence of the case was that USSL's directors were said to have improperly proposed changes to the benefit and contribution structure of the Scheme.

In a judgment handed down by Leech J on 24 May 2022, following a hearing, the High Court dismissed the application.[1] The claimants then appealed to the Court of Appeal, where their appeal was dismissed in a judgment handed down on 21 July 2023.[2]

The 'central issue' for the courts to determine was whether the claim was properly brought as a multiple derivative claim.[3] The situation was unusual. USSL is a company limited by guarantee and had no members

other than its directors. Nor were the claimants shareholders (or members in the corporate sense) of the Scheme. They were interested in the Scheme as beneficiaries of the trust constituting the Scheme.

At first instance, Leech J took a somewhat expansive view of what might constitute a multiple derivative claim. In particular, he held that USSL was in his judgment right not to submit there could never be a case in which members of a pension scheme could bring a multiple derivative claim.[4]

The Court of Appeal took a more restrictive view. Giving the leading judgment, Asplin LJ pointed out that although the claimants have an interest in the Scheme as beneficiaries, USSL has a separate legal personality from the Scheme. 'The fact that Dr McGaughey and Prof. Davies are members of the Scheme does not place them in a position which is analogous to the position of a shareholder in a company derivative action.'[5] This proved fatal to the case. Asplin LJ concluded that 'it seems to me that [the claimants] are seeking to interfere with the decision making of the trustee company and to do so without seeking to bring an action against USSL itself'.[6] The Court of Appeal noted that the case may have been better brought in trust law.[7] This would have required the claimants to demonstrate that they represented the beneficiaries of the Scheme and, unlike a derivative claim, would have precluded seeking an indemnity for costs from USSL.[8] However, as noted by the court, 'the derivative procedural mechanism is not intended to enable would be claimants to avoid other procedural hurdles.'[9]

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1 *McGaughey v Universities Superannuation Scheme Limited* [2022] EWHC 1233 (Ch), [2022] Bus LR 797.
2 *McGaughey v Universities Superannuation Scheme Limited* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319.
3 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [61].
4 *McGaughey* [2022] EWHC 1233 (Ch), [2022] Bus LR 797 at [28].
5 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [118].
6 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [165].
7 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [178].
8 CPR 19.8 and 19.19.
9 *McGaughey* [2023] EWCA Civ 873, [2024] 1 All ER (Comm) 319 at [186].

Conclusion – Future Significance of *ClientEarth* and *McGaughey* for Shareholder Activism

SR1[5] *ClientEarth* and *McGaughey* show that derivative claims are unlikely to prove fruitful for shareholder activists. There are a few key takeaways in this respect.

First, the cases indicate that the courts may be reluctant to find the derivative action to be the proper procedure for activist claims. The Court of Appeal's decision in *McGaughey* makes plain that the common law derivative action is not the proper venue for members of pension funds to bring claims against the directors of corporate trustees (which, in practice,

control pension funds' investment decisions). And in *ClientEarth*, although the High Court did not dispute ClientEarth's standing to seek permission to continue a statutory derivative claim against Shell, ClientEarth's small shareholding does seem to have led the court to infer that ClientEarth was not acting in good faith.

Secondly, the courts continue to defer to directors' discretion in decision-making. When considering whether Shell's directors had breached their duties, the court was satisfied by the fact that the directors had turned their minds toward the relevant issues. The court considered that the relative importance to be attached to these issues is properly for a company's directors to determine. This follows the courts' approach to issues like this in the past and is a common defence in fiduciary duty cases.

Thirdly, the fact that the company's entitlement to the relief claimed will form part of the court's assessment of whether to allow a derivative claim to proceed beyond the prima facie stage imposes an additional hurdle. Injunctions and declaratory relief, although superficially attractive from an activist's perspective, sit uncomfortably alongside the principle, derived from the fourth exception to *Foss v Harbottle* and clearly still relied on by the courts even when a statutory derivative procedure is being followed, that derivative claims serve to right a wrong suffered by the company. An actionable wrong presupposes the sufferance of a loss, and damages are likely to be the appropriate remedy. The burden is on the claimants to show the loss suffered. Although loss may be hard to prove, the cases show that the courts are not willing, as a substitute to proving loss, to grant injunctions that are difficult to police or declarations that do little to compensate for the alleged wrong.

Finally, the costs order granted in favour of Shell is likely to encourage companies to defend derivative claims more vigorously at the prima facie stage. In turn, this raises the prospect that activists may have to pay substantial costs should they lose.

Altogether, this is reassuring for boards. Activists are likely to be better off seeking to influence board decisions by more conventional means, rather than through litigation. These include engaging with, and challenging, management in general meetings. The Act provides a toolkit, including the ability to require directors to call a general meeting, and propose a specific resolution, at the request of shareholders carrying at least 5 per cent of the company's shares.[1] Moreover, the directors of listed companies are usually subject to annual re-election.[2] The challenge for activists in using these methods lies, of course, in persuading other shareholders of their mission. But if the intent is to embed ESG matters in corporate decision-making, longer-term stewardship may prove more sustainable than the sugar rush of litigation. Perhaps it is no bad thing for *ClientEarth* and *McGaughey* to suggest that the bar to success in derivative claims remains high.

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1 Companies Act 2006, s 303.
2 The UK Corporate Governance Code, 2018, provision 18.