



Restitution or windfall?

Court Certifies class action for consumers who suffered no damages

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Can consumers who obtain a defective product for free recover profits earned by the manufacturer, even though those consumers suffer no damages whatsoever? Most non-lawyers would likely say: no. However, the Ontario Divisional Court recently affirmed a decision certifying a class action against Johnson & Johnson that raises this question.¹

Before certifying a class proceeding, the court must consider whether the proposed class proceeding raises a valid cause of action. Courts are extremely reluctant to dismiss law suits before trial. Before a court can strike a statement of claim as not disclosing a cause of action, it must conclude that it is "plain and obvious" that the claim will fail. If it were not so, the common law might be unable to develop new causes of action to respond to new injustices.

However, the decision of the Ontario Divisional Court in *Serhan Estate v. Johnson & Johnson* tests the limits of this principle. In that case, the court affirmed the decision of Mr. Justice Cullity of the Superior Court to certify a class action where:

- the plaintiffs suffered no loss at all;
- the cause of action, "waiver of tort", may not be an independent cause of action; and
- the case does not meet the requirements for obtaining a constructive trust established by the Supreme Court.

Johnson & Johnson knowingly markets defective product

In the 1990s, a LifeScan, Inc., and LifeScan Canada Ltd., both subsidiaries of Johnson & Johnson, marketed a blood monitoring device called the

SureStep System. SureStep allowed diabetics to measure their own blood glucose levels by pricking a finger, applying blood to a strip of paper, and inserting the paper into the device. However, SureStep had two defects. The first was a software bug that sometimes reported an error. The second was a defect in the strips: if they were not inserted fully, the machine might report a lower than actual glucose reading.

Importantly, Johnson & Johnson knew about these defects before introducing SureStep, but marketed it anyway. It failed to remedy these defects after receiving complaints, and even submitted false reports to a US government agency. Johnson & Johnson did not fix the product until years later. In 2000, the company pleaded guilty in the US to various charges and paid fines of about US\$60 million. Ultimately, Johnson & Johnson recalled and replaced the machines in Canada.

A proposed class proceeding was then commenced in Ontario alleging, among other things, negligence, negligent and fraudulent misrepresentation, misleading advertising, and conspiracy. Apart from damages, the plaintiffs claimed disgorgement of profits and that Johnson & Johnson holds revenues from the sale of SureStep in constructive trust for the plaintiffs.

However, evidence on the certification motion showed that the plaintiffs had not suffered any damages at all. No one's health was impacted, nor did anyone lose any income. The representative plaintiffs did not even pay for the product: they obtained the machines for free from hospitals and the strips through a government drug benefit plan (with a fee of \$2 per prescription). The most that could be said was that the representative plaintiffs

were forced to prick their fingers a second time to obtain another blood sample because of the machine's errors.

The test for certification of a class proceeding

The requirements that a proposed class proceeding must meet to be certified include the following:

- The pleadings must disclose a cause of action;
- There must be common issues; and
- A class proceeding must be the preferable procedure for the resolution of the common issues.

While all of the requirements for certification have been debated in certification motions, the existence of common issues and the preferable procedure requirement tend to be the most hotly contested. In this case, however, much of the argument turned on the first requirement, that is, that the pleadings disclose a cause of action.

The test for determining whether the pleadings in a proposed class proceeding disclose a cause of action is the same as that applied where a party moves to strike a pleading: it is plain and obvious that the claim will fail?² If it is not, the requirement is met and the analysis moves to the other requirements.

The certification decision

Cullity J. considered whether the pleadings disclosed a cause of action in respect of the plaintiffs' entitlement to the remedy of constructive trust on a theory of waiver of tort. He held that although there were difficulties with the claim, it was not plain and obvious that it would fail.

Cullity J. then considered the thirteen common issues proposed by the plaintiffs and accepted only four, dealing mainly with the plaintiffs' entitlement to be paid the money Johnson & Johnson made from the SureStep System on a constructive trust or restitutionary basis.

The appeal

The defendants appealed to the Divisional Court, after obtaining leave to appeal.³ The Divisional Court affirmed Cullity J.'s decision, with Madam Justice Chapnik dissenting. The Ontario Court of Appeal has refused leave to appeal this decision. Johnson & Johnson is seeking leave to appeal to the Supreme Court of Canada.

Test to be applied to pleadings on a certification motion

Writing for herself and Mr. Justice Jennings, Madam Justice Epstein began by confirming that the test for determining whether the pleadings in a proposed class proceeding disclose a cause of action is the same as that applied where a party moves to strike a pleading: it is plain and obvious that the claim will fail? She rejected the suggestion that a more liberal test should be applied to class proceedings. The *Class Proceedings Act* is a procedural statute only; it is not meant to change the substantive rights of parties.

Waiver of tort as a cause of action

Waiver of tort is a restitutionary doctrine that allows a plaintiff in certain circumstances to elect to obtain a restitutionary remedy (such as disgorgement of profits) instead of the normal tort measure of damages. In making this election, the plaintiff must give up the right to sue in tort for damages, thus, waive the tort. Where, for example, a plaintiff is defrauded, and the fraudster makes more than the plaintiff loses, the plaintiff will want to elect a restitutionary remedy.

The question raised by *Serhan* is whether waiver of tort requires an underlying tort that is waived. It raises this question because the torts pleaded by the plaintiffs require proof of at least some loss as an essential element.

Epstein J. canvassed cases and academic opinion on this issue. Both are divided. Some argue that it is not necessary to establish a tort to claim under waiver of tort. Rather, waiver of tort exists to compel a wrongdoer to disgorge an unjust enrichment⁴ gained through any type of wrongdoing. It is thus an independent cause of action.

Others argue the opposite: it is fundamental to the doctrine of waiver of tort that a tort have been committed.

In the face of such a disagreement among the authorities, it is clear that whether waiver of tort is a cause of action cannot be determined on a pleadings motion. Chapnik J. agreed with the majority on this point.

Availability of constructive trust

Constructive trust is an equitable remedy whereby the court deems that property or money held by one person is held in trust for another, as a result of some wrongdoing on the part of the person holding the property or money.

The Divisional Court considered the leading case of *Soulos v. Korkontzilas*,⁵ in which the Supreme Court expanded the availability of the remedy of constructive trust to situations where “good conscience” requires the court to impose it to do justice and “maintain the integrity of important institutions dependent on trust-like relationships”. Korkontzilas was a real estate broker who diverted a building purchase from his client, Soulos, to his wife.

In *Soulos*, McLachlin J., writing for the majority, identified four conditions that should “generally be satisfied” for constructive trust to be awarded.

- (1) The defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets in his hands;
- (2) The assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;
- (3) The plaintiff must show a legitimate reason for seeking a proprietary remedy, either personal or related to the need to ensure that others like the defendant remain faithful to their duties and;
- (4) There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the

interests of intervening creditors must be protected.

Turning to the first condition, Epstein J. suggested that courts might be prepared to recognize an equitable obligation on the part of manufacturers of health products toward consumers – who are “in a vulnerable position in relying on the products”. She also cited a number of case comments that question whether the availability of constructive trust should be limited to cases involving an equitable obligation. She concluded that these were policy issues that cannot be decided on a certification motion.

Epstein J. recognized, as had Cullity J., that the case involved no agency relationship. She suggested, however, that McLachlin J.’s reasoning is “based on a general relationship recognized in equity, rather than an agency relationship specifically”. She thus concluded that the question of whether the remedy is limited to agents should go to trial.

As to the requirement that plaintiffs show a legitimate reason for seeking a proprietary remedy, Epstein J. held that the fact that the plaintiffs had paid no money was not fatal to the claim at the certification stage.

Finally, Epstein J. held that where there are factors that would render the imposition of a constructive trust unjust must be determined on the facts.

In summarizing, Epstein J. acknowledged the force of the defendants’ arguments that the plaintiffs could not meet the four requirements set out in *Soulos*, but that these arguments raised important policy issues that must be determined on a complete factual record.

Accounting and disgorgement of profits

The plaintiffs also assert an entitlement to the profits earned by Johnson & Johnson on the basis that a wrong-doer should be deprived of the benefit obtained through wrong-doing, even in the absence of loss to the plaintiffs. Epstein J. noted the debate about whether disgorgement can be an appropriate remedy where no property of the plaintiff is taken. She held that this issue, as well as the very nature of the remedy of disgorgement, needs clarification.

Legally incoherent?

Epstein J. concluded by expressing doubts about the validity of the plaintiffs' claim. She noted that Johnson & Johnson undoubtedly was enriched, and asked rhetorically whether it was not unjust to allow them to retain such enrichment. But, she added,

However, connecting these plaintiffs with these gains in a legally coherent fashion is the problem that lies at the root of the challenge to the certification of this class proceeding. The remedy the plaintiffs seek may leave them better off than if the events had never occurred. The possibility of a windfall gain bothers some. The possibility of leaving the defendants with their ill-gotten gains, bothers many.

Combined absence of elements

Chapnik J. dissented. She agreed that whether waiver of tort is an independent cause of action could not be determined on a certification motion. However, she held that it was plain and obvious that the plaintiffs are not entitled to the restitutionary relief claimed because of the "combined absence of the elements of unjust enrichment, any trust-like relationship, or any sort of calculable loss or ongoing deprivation suffered by the representative plaintiffs or members of the putative class in relation to the defendants' profits".

Elaborating on the first, unjust enrichment, Chapnik J. pointed to the requirement of this cause of action that the plaintiffs have suffered a deprivation that corresponds to the defendants' enrichment. Here there was no such deprivation. "Recovery cannot be predicated on the bare assertion that fairness so requires", she stated.

Turning to constructive trust, Chapnik J. observed that at least two of the four requirements laid down by the Supreme Court in *Soulos* were not satisfied. Nothing in *Soulos* could justify finding a "trust like" duty in this case, nor was there a direct relationship between the parties akin to an agency relationship.

Chapnik J. found that the claim for disgorgement challenged the boundaries of tort law, and that there is "no principled basis upon which the remedy of disgorgement might be available".

Not the preferable procedure

Chapnik J. then expressed the view that a class proceeding would not be the preferable procedure for resolving the common issues. She recalled the legislative goals of class proceedings: access to justice, judicial efficiency, and behaviour modification.

Certification of the case brings strict liability to Canadian products liability law, she held, since the only goal served by certification would be behaviour modification. She noted that the behaviour modification goal has reduced significance because Johnson & Johnson recalled the defective products and paid heavy fines in the US.

Chapnik J. then noted the serious consequences on defendants of allowing class actions to proceed. The risks posed by class actions and the costs of defending them lead even defendants who have done nothing wrong to settle.

The Chancellor's Foot

The rule that a cause of action will not be struck because of novelty is well, and properly, entrenched in Canadian law. Long ago the Common Law shed the formal requirements of the writ system and adopted a flexible approach to new causes of action perhaps best summed up by the maxim, "where there is a right, there is a remedy".⁶

But the *Serhan* case surely tests the boundaries of even the most flexible approach to novel legal claims. What is remarkable about *Serhan* is that for the plaintiffs to win, they must convince a court to establish waiver of tort as an independent cause of action and then widen almost beyond recognition – or ignore – the requirements laid down by the Supreme Court for granting restitutionary relief.

To do so may have a number of ill effects. It would collapse the test for obtaining a constructive trust remedy down to "good conscience", a test hardly different from the proverbial length of the Chancellor's foot. This would deprive courts of a workable test for granting constructive trust remedies and citizens of certainty as to the law.

Applying a constructive trust remedy to a product liability case also means that the relationship of

manufacturer and end user attains the status of an equitable relationship like that of trustee and beneficiary or agent and principal. There would be no reason to stop there, however. The reasoning that supports enforcing this relationship through equity could easily apply to parties to a contract, potentially turning all commercial relationships into equitable ones with the heightened duties that equity involves.

Much of Epstein J.'s reasoning appears to be based on the notion that Johnson & Johnson should not be entitled to keep their ill-gotten gains. On this theory, allowing a plaintiff who has not suffered damages to recover might make sense, so long as there is no alternative plaintiff who has suffered a loss. In *Serhan*, however, there appear to be potential plaintiffs who have suffered damages: the hospitals and drug plans that paid Johnson & Johnson for defective equipment. To allow a set of plaintiffs who did not suffer a loss to recover creates the risk that the defendants will face double civil liability if the hospitals and drug plans also sue.

In invoking waiver of tort, a plaintiff makes a choice between two possible remedies: damages or constructive trust. The plaintiff cannot have both, in part because it is wrong to grant double recovery to

the plaintiff and impose double liability on the defendant. However, if a plaintiff who has not suffered damages can recover the wrong-doer's profits, what can the plaintiff who has suffered damages get? Is the plaintiff who suffered damages limited to actual damages if the non-inured plaintiff has scooped the wrong-doer's profits? Or does the election of the first plaintiff in the door mean there is nothing for the plaintiff who actually suffered a loss?

It must be kept in mind, however, that this decision does not say that waiver of tort is an independent tort, or that the *Serhan* plaintiffs can recover Johnson & Johnson's profits in these extraordinary circumstances. All it says is that it is not plain and obvious that they cannot. It is true that certifying such a claim as a class proceeding presents Johnson & Johnson with an unenviable choice between costly litigation, even if the risk of loss is small, and costly settlement. But class proceedings legislation gives rise to this choice by its very nature. It is not a reason to impose a higher standard on pleadings in a class proceeding than is imposed on pleadings in other litigation.



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¹ *Serhan Estate v. Johnson & Johnson*, [2006] O.J. No. 2421

² This test was laid down by the Supreme Court in *Hunt v. Carey Canada Inc.*, [1990] 2 S.C.R. 959.

³ The Divisional Court is a branch of the Superior Court that hears appeals from interlocutory orders as well as applications for judicial review.

⁴ See ¶54. Epstein J.'s use of the term "unjust enrichment" is odd, since unjust enrichment as a cause of action requires that the plaintiff suffer a corresponding deprivation, that is, a loss. There cannot be an unjust enrichment in the air, any more than there can be negligence in the air.

⁵ [1997] 2 S.C.R. 217

⁶ In Latin, *ubi ius, ibi remedium*.