



An Article by Peter H. Gunst

## **Can big box stores sell products below cost as a loss leader?:**

### **An example from the petroleum industry.**

#### Predatory pricing theory

In the archetypal predatory pricing theory, the large predatory company lowers its price below the average cost of its small competitors. In response, the small competitors must meet this price by lowering their prices below average cost and they are driven out of the business by continued selling at a loss. If the small competitors do not lower their price their business is destroyed by loss of market share.

Eventually the predatory company wipes out the competition and can then recoup its losses through monopolistic pricing.

#### Loss leader as a predatory practice

Selling a product as a loss leader is a variant of the basic predatory pricing theory. Instead of selling a product at a loss for a short time with a view of raising the price once the competition is wiped out, a predatory company may never need to sell the loss-leading product above average cost. The loss-leading product attracts customers to the predatory company and once at the store, the customers will purchase other

high margin products. The profit from the high margin sales offsets the losses from the loss-leading product.

The impact on small competitors from a loss leading predatory firm can be significant. Compare for example a big box retailer with thousands of product lines versus a small tire retailer with a relatively undiversified product line consisting of tires and tire related products. If the big box retailer begins to sell tires below average cost to get customers in the door, a small tire dealer next door may have no choice but to lower price accordingly. If loss leading tire sales represent 1% of big box's business whereas below average cost sales for small tire dealer represent 90% of business, it is not difficult to see that the small dealer will go out of business while the big box retailer will be able to maintain losses on the loss leading product. So what's a small retailer to do?

#### State Law may provide a remedy

About half of the States have unfair sales acts that are designed to combat predatory below cost pricing. The typical act prohibits the sale of products at less than the cost to the retailer when that retailer has the intent of injuring competitors or destroying competition. Commonly, unfair sales acts begin the analysis by determining the cost of goods to the retailer. Freight, taxes and a statutory minimum markup are added to the cost of goods to determine the minimum cost against which a predator's prices are adjudged. The statutory defined minimum markup represents the cost of doing business and may be rebutted by evidence of a lower cost by the predatory company. If a competitor can demonstrate that the predator's price is below the statutory

minimum price and that the price was set with an impermissible intent to injure competitors then the violation of the unfair sales act may entitle the competitor to damages and/or injunctive relief.

### Petroleum Industry Example

In recent years, big box retailers such as Sam's Club and Wal-Mart have had several run-ins with state unfair sales acts for alleged predatory pricing practices. Earlier this year in *Star Fuel Marts, LLC v. Murphy Oil USA, Inc.*, 2003-1 Trade Cases 74,001, 2003 WL 742191 (W.D. Okla. 2003), an Oklahoma U.S. District Court found that Sam's Club had violated the state's Unfair Sales Act by selling gasoline at below cost in order to induce customers to purchase club memberships and increase total purchasing in the stores. Sam's Club was using gasoline as a loss leader to attract customers to its stores to increase the number of paying members as well as overall sales.

The court determined that Sam's Club was selling gasoline below cost. Next, the court examined whether there was an intent to harm competition. The court applied the Oklahoma statutory provision that below cost pricing constitutes prima facie evidence of the requisite intent to injure competitors and to destroy or substantially lessen competition. 15 Okla. St. § 598.5.

The prima facie evidence provision relieved the plaintiff competitor from having to prove the competitive harm on the market by the defendant's predatory conduct. Sam's Club was unable to satisfactorily rebut this prima facie evidence and the Court

found that Sam's Club was selling gasoline below the statutory minimum price of wholesale cost plus freight and taxes plus 6% markup.

Sam's Club argued that it was meeting the competition from various dealers' rebate programs. While meeting a competitor's price is generally acceptable, in this instance, the court was not persuaded.

The result: Sam's Club was enjoined from continuing to sell gasoline below cost at the complained of stores.

### Tire Sales Next?

Ever expansionist, big box retailers are predictably growing their presence in the retail tire business. Tire dealers that experience below cost pricing by big box retailers may want to consider their state's unfair sales act to restrain anti-competitive practices from the big guys. Dealers may want to:

First, check whether your state has an unfair sales act.

Second, examine how the statute calculates the minimum cost.

Third, determine what is the prohibited purpose and if are there any presumptions or prima facie evidence provisions.

Fourth, are there any exceptions to the applicability of the statute such as a good faith attempt by the company to meet the competition or an exception for temporary events such as a grand opening or liquidation sale.

Remember, aggressive pricing is generally not prohibited unless the price is below cost AND an improper purpose can be demonstrated either by direct evidence or a burden shifting provision such as a prima facie evidence provision in the state's unfair sales act. A state unfair competition act may provide one avenue of redress.