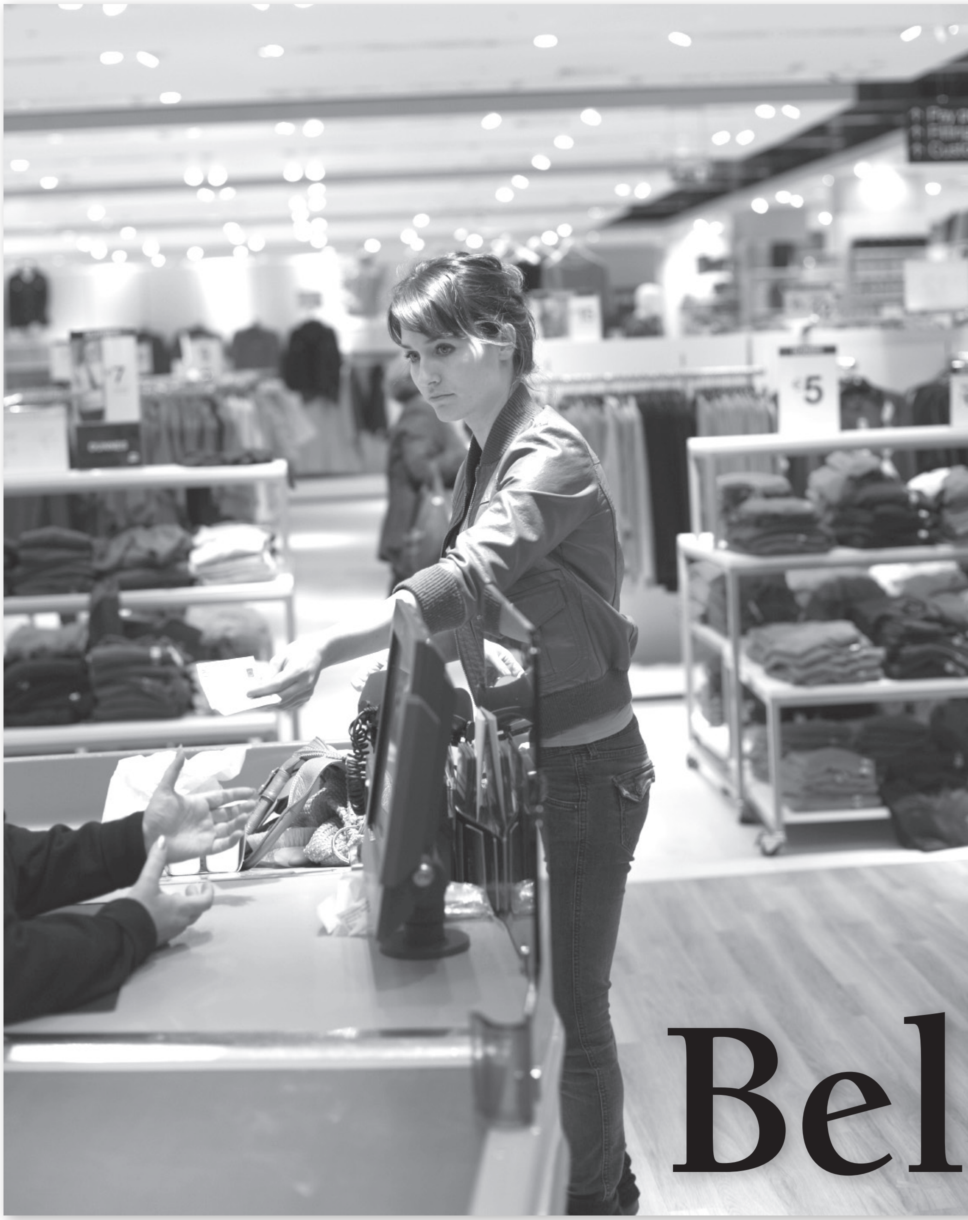
The Case Against Below-Cost Prohibition Statutes



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by Kwabena Offei-Danso [1]

I. Introduction

The thought of legislatures creating laws that raise the price of goods makes many cringe.[2] Yet a majority of states have passed statutes forbidding the sale of certain goods (mostly necessities) below the seller's costs, accordingly resulting in higher prices.[3] The goals of such statutes are to protect consumers from predatory pricing and to guard against the unfair marketing practice of luring consumers with "loss leaders" only to charge more on other goods.[4] Proponents of these regulations have produced some evidence showing the regulations achieve their purposes.[5] However, the costs involved with passing and enforcing these statutes, as well as complying with and defending against alleged violations of these statutes, severely outweigh the benefits, leading to the conclusion that their enactment and enforcement should be curbed.

II. Mechanics of Profiting From Below-Cost Selling

The motive behind pricing goods at less than seller's costs is generally deferred profits.[6] Profiting from below-cost selling is often achieved by applying one of two methods or a combination of both.[7] With the first method, the seller lowers the price of goods below their cost of production to the extent that other competitors can no longer compete on price.[8] When the competition exits the market, the seller steps up and charges monopolistic prices, thereby recovering its lost profits and more.[9] Due to the steep losses such sellers would have to take; only entities with expansive financial resources can afford to do this.[10]

The second method involves the use of below-cost prices as a means of getting customers into the store.[11] The seller in this case creates a "loss leader" product.[12] Purchasing customers, who are attracted by the extremely low prices, are then trapped into buying other products sold by the seller, enabling the seller to recuperate its losses from the sale of the "loss leader" item.[13] Sellers accomplish this end by offering discount sales and rebates through card and cash back schemes.[14] Large retailers have been noted as regular culprits in using gasoline as a "loss leader."[15] These retailers allow customers to receive gift and membership cards that permit customers to purchase gasoline below the retailers' costs while steering them to other products on the shelves.[16] Remarkably, retailers who employ this scheme are often motivated by innovative marketing rather than monopolization.[17]

III. Overview of Below-Cost Prohibition Statutes

As a general rule, one may sell to whomever she wants under whatever price she establishes.[18] However, she may not sell at a predatory price when it is in violation of antitrust laws.[19] Currently, over twenty states have enacted below-cost selling laws.[20] The exclusive list of states, as of October 2010, includes Arkansas, California, Colorado, Hawaii, Idaho, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, Nebraska, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.[21] While no federal law expressly deals with below-cost selling,[22] courts and regulators have disallowed such practices by asserting violations of the Sherman Act, the Clayton Act, and the Robinson Patman Act.[23]

State below-cost prohibition statutes generally prohibit charging customers below the cost of purchase or manufacture of a product.[24] These statutes are often designed to affect specific products.[25] Some states, though, have general statutes which affect the sale of all products.[26] The statutes are designed to accomplish two purposes: (i) to prevent loss leader selling and (ii) to shelter other merchants from predatory pricing.[27]

IV. Standing to Enforce Below-Cost Prohibition Violations

Below-cost prohibition statutes are enforceable by the state attorney general and, in many cases, by private parties.[28] The various state statutes contain provisions granting private parties standing to sue (and/or recover) for antitrust injuries.[29] Where private parties are permitted to enforce antitrust violations, state courts have generally required that the suing parties have suffered "antitrust injuries". The twofold determination of "antitrust injury" demands that the harm be (i) the type the statute seeks to prevent,[30] and (ii) proximately and directly caused by the violation and not by other, non-violating actions.[31]

V. Issues With Below-Cost Prohibition Statutes

The negative consequences of below-cost prohibition statutes outweigh the benefits by far.[32] These statutes, which tend to be exceedingly complex and force sellers to take extraordinary precautions, increase costs while failing to fully protect against that which they seek to prevent (i.e. anti-competitive practices). In some cases, these regulations actually result in a decrease in competition. At the same time, taxpayers bear the unreasonable costs of implementing and enforcing these imperfect statutes, which are often found to be unconstitutional. In sum, the resulting costs incurred by passing these statutes by far exceed the utility to society.

A. Below-Cost Statutes Generally Result in Decrease In Competition.

1. The complexity in determining violations of below-cost prohibition statutes creates uncertainty, thereby increasing costs to sellers and eventually causing small retailers to resist entry into the market or abandon the market.

Below-cost prohibition statutes generally require proof of "costs"[33] of a seller in order to show it sold below its costs.[34] The determination of costs is so complicated that it creates an unreasonable burden on merchants. Most state statutes define "costs" as the marginal cost of seller.[35] In these states, prices above the seller's marginal costs are presumed to be lawful (unless revealed to be predatory in certain special circumstances), while prices below are deemed unlawful.[36] Some states have variations of this rule to deal with other factors such as seller's pricing behaviors.[37] A number of states have also considered the "cost of doing business" in the calculation of "costs".[38] To do this, certain fixed costs are accounted for.[39] These costs may include rental and/or depreciation costs and salaries of employees.[40] A small minority of the states that apply the "cost of doing business" standard have also created percentage presumptions of fixed costs.[41] An example is Alabama, which presumes six percent of invoice costs are fixed costs unless the evidence points to the contrary.[42]

The legal presumption of knowledge [43] compels a seller to: (i) find the statute which deals with below-cost prohibitions, (ii) determine his costs while considering the uncertainty that his calculations may be wrong, and (iii) include a small premium to cushion against the probability of his calculations being wrong.[44] The alternative is to retain the services of an attorney who specializes in anti-trust law to make this determination. Individuals and entities with limited financial resources and who cannot stomach the risk of miscalculation are tempted or forced to exit the market or resist entry to the market, which leaves room only for bigger players - the result which the statutes seek to prevent.

2. The presence of valid defenses does not vitiate the costs involved in litigation.

To prevent the violation of the various state constitutions and to ensure below-cost prohibition statutes are strictly construed, state legislatures have enacted defenses to actions brought under these statutes.[45] These defenses include sales made in good faith, *bona fide* clearance sales, isolated transactions not in the usual course of business, good faith effort to meet competition, liquidation of business, sales of imperfect/damaged products, and sales under direction of a court.[46]

However, it is important to note these defenses must be presented in a court of law. Hence, a seller would first have to be haled to court (in the absence of a settlement) before being given opportunity to assert its position, expending precious time and resources in the process.[47]

B. Giving Away Products May Easily Circumvent What a Majority of Below-Cost Prohibition Statutes Seek to Prevent.

These seemingly airtight regulations have a significant loophole, which could easily be used by larger competitors to defeat enforcement.[48] Under all the statutes reviewed, in order for a below-cost prohibition violation to exist, the seller must have "sold" a good.[49] The statutes generally do not forbid a larger competitor with monopolistic intent from giving away products. Assuming this can be done without violating other federal and state antitrust laws, it could lead to the same result as selling a good below its cost. Giving away products may be used to invite and capture customers to purchase other goods sold at a premium.[50] If giveaways continue over a long period of time without much loss to a seller, he could effectively drive off competition and charge monopolistic prices.[51]

C. The High Cost of Enforcing Often Flawed Below-Cost Prohibition Statutes Requires That Their Passage be Curbed.

In addition to ordinary costs involved with the passage and implementation of legislation in general, the cost of passing below-cost prohibitions statutes are astronomically increased by the fact that they are routinely found to be unconstitutional.[52] Taxpayers are unfairly burdened with the unnecessary costs of enacting flawed statutes and fighting constitutional challenges to enforcement. A statute will generally pass constitutional muster "[when] the legislation is designed to accomplish an end within legislative competence and [when] the means it employs are reasonably designed to accomplish that end without unduly infringing upon protected rights."[53] Quite often, these statutes do not meet the above standard and are struck down as (i) unreasonable, (ii) vague, or (iii) in violation of equal protection or due process.

Several courts have found below-cost statutes to be unreasonable when they have not given sellers enough notice or where their enforcement would lead to the state meddling in the affairs of private enterprise.[54] For example, in *Drink, Inc. v. Babcock*, 421 P2d 798 (NM 1966), the Supreme Court of New Mexico held a New Mexico statute unconstitutional where it determined that the statute fought not to protect the safety and wellness of the people, but to make a conduct unlawful.[55] The court was determining the constitutionality of a liquor price statute whose purpose was to set uniform prices by requiring a minimum markup over the contract price.[56] The court's holding noted "the legislature may not, in the guise of protecting the public interest, arbitrarily or unreasonably interfere with private interests."[57] It added "[a] claim that a statutory restriction is in the public interest cannot rest on mere conjecture, but must be supported by something of substance."[58] Faced with a similar situation, the Alabama Supreme Court struck down several provisions of the Alabama Motor Fuel Marketing Act.[59] The court's reasoning was that the provisions were against the liberty interests granted by the Alabama State Constitution.[60] The unconstitutional provisions allowed a person with standing to make a *prima facie* showing of a violation by proving the seller sold goods below its costs.[61] The court mentioned that permitting enforcement would lead to excessive meddling into private contracts.[62] The court implied in its holding that the portions of the statute which were struck were unreasonable.[63]

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At least two state courts have invalidated below-cost prohibition statutes for being unconstitutionally vague.[64] The test for vagueness is whether a statute is sufficiently definite in its terms to be enforceable.[65] Where statutes are criminal in nature, courts have required a mental state (criminal intent) in order to find sufficient definiteness. For example, in *State ex rel. Anderson v. Fleming Co.,* 339 P.2d 12, 18 (Kan. 1959), the Kansas Supreme Court found a criminal statute which forbade the sale of milk "below-cost at point of delivery" unconstitutionally vague and criticized its lack of a requirement of criminal intent. Other courts have gone a step further and found it unreasonable and unconstitutional to legislate civil statutes which do not require a showing of intent.[66]

Several below-cost prohibition laws have also been found to violate equal protection and due process clauses of state constitutions.[67] For example, the Supreme Court of Kentucky in *Remote Services Inc v. FDR Corp.*, 764 S.W.2d 80 (Ky. 1989), declared a Kentucky "minimum markup" statute as unconstitutional because it interfered with the due process right to contract and also led to unequal enforcement in violation of the state's equal protection statute. The Georgia Supreme Court has also adopted this line of reasoning in holding that there could be no

abrogation of the state's constitutional due process right to contract absent a significant public interest.[68] The Georgia Supreme Court found no public interest in regulating only the sale and resale of gasoline while neglecting other sectors of the petroleum industry.[69] Although a numerical figure weighing the additional cost of implementation to the actual benefits derived from these statutes is hard to determine, it is clear that additional costs created by the possibility of finding these statutes unconstitutional reduces the attractiveness of the already flawed anti-competition statutes.

CONCLUSION

Below-cost prohibition statutes are designed to curb profiteering and encourage competition. However, their implementation often leads to complex rules whose interpretation is cumbersome. The implementation and interpretation of these statutes is also so expensive that it has the effect of creating barriers to entry for smaller competitors and, in some cases, forcing them out of the market. Furthermore, these statutes are plagued by constitutional pitfalls which create additional costs for taxpayers. The evaluation of the major deficiencies surrounding the implementation and enforcement of below-cost prohibition statutes lead to only one logical conclusion – states should abrogate laws that attempt to bar below-cost pricing.

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2 St. Petersburg Times, Tuesday, March 7, 2000 at 1.A.
3 *See, e.g.,* Motor Fuel Marketing Practices Act, Fla. Stat. ch. 526.302; Tennessee Below Cost Act, Tenn. Code Ann. § 47-25-109 (1907); Alabama Motor Fuel Marketing Act, Ala. Code § 8-22-1 (1984).
4 *See generally* Erin Masson Wirth, *Validity, Construction, and Application of State Statutory Provisions Prohibiting Sale of Gasoline Below Cost,* 26 A.L.R. 6TH 249, § 2 (2007).
5 *See generally* Morgan, *supra* note 2, at 1.A.
6 *See* Wirth, *supra* note 4, § 2.
7 *See Id.*; Morgan, *supra* note 2, at 1.A.
8 *See generally Id.*
9 *Id.*
10 *Id.*
11 *See* Morgan, supra note 2, at 1.A. (Roger D. Blair of University of Florida found Wal-Mart used this method to lure shoppers).
12 *See generally Id.*
13 *Id.*
14 *See generally* Jennifer M. Evans, *Pricing at the Pump: The Impact of Recent Litigation on the Interpretation of Below Cost Motor Fuel Statutes*, 21 Ga. St. U. L. Rev. 1055, 1065–1072 (2005).
15 *See generally* Morgan, supra note 2, at 1.A.
16 *Id.*
17 *See generally* Wirth, *supra* note 4, § 2.
18 *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919).
19 *Id.*
20 Penelope A. Preovolos, *Unfair Practices and Predatory Pricing*, 1648 PLI/Corp 201 (2008).
21 *Id.*
22 This essay will only address the issues with state below-cost prohibition statutes.
23 Francis Amendola, et al., *Trade-Marks, Trade-names, and Unfair Competition*, 87 C.J.S. Trade Marks, Etc § 383 (2008). A violation of these Acts (and in particular, the Sherman Act) is said to occur where below-cost selling becomes predatory. William C. Homes, *Predatory Pricing: bundled discounts*, Antitrust Law Handbook § 3:14 (2008).
24 *See, e.g.,* Fla. Stat. ch. 526.302; Tenn. Code Ann. § 47-25-109; Ala. Code § 8-22-1
25 *See, e.g.,* Fla. Stat. ch. 526.302
26 *See, e.g.,* Tenn. Code Ann. § 47-25-109.
27 *See generally* Wirth, *supra* note 4, § 2.
28 Stephen V. Bomse, et al., *Procedural Aspects of private antitrust litigation*, Practicing Law Institute 787 (2008); In the case of Florida, the Department of Agriculture and Consumer Protection also has jurisdiction to prosecute a violation of this statute. Fla. Stat. ch. 526.311.
29 *See* Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328 (1990) (delineating that the determination of an antitrust injury is twofold. First, the harm must be of the type the statute seeks to prevent. And second, the harm must be proximately and directly caused by the violating party's actions and not by others); *See also* Bomse, supra note 28 (stating that in most state court disputes touching on antitrust violations, including below cost prohibition violations, the state courts have followed federal law's stance regarding injury).
30 *Id.*
31 Homes, *supra* note 23, at § 9:8.
32 This is notwithstanding some studies which have concluded that states' enactment of below cost sale prohibition statutes have lead to a reduction in prices. *See* Evans, *supra* note 14, at 1060.
33 *See, e.g.*, Ala. Code § 8-22-1; Fla. Stat. ch. 526.301 – .309 (deriving "cost" from the average cost of the good several days prior to the date of the sale).
34 *See, e.g., Id.*
35 Evans, *supra* note 14, at 1062; *See, e.g.,* Md. Code Ann., Bus. Reg. § 10-301 (2002) (defining cost as the most recent Oil Price Information Services (OPIS) average reseller rack cost, the freight charges, and all applicable federal state and local taxes not included in invoice cost).
36 *Id.*; Unfair Sales Act, Wis. Stat. § 100.30 (2004) (declared unconstitutional in *Flying J, Inc. v. Van Hollen*, 597 F. Supp. 2d 848 (E.D. Wis. 2009)).
37 Evans, *supra* note 14 (citing Unfair Sales Act, Wis. Stat. § 100.30). Wisconsin's statute included the average variable cost in the calculation of costs as well as a 9.18% markup to serve as a cushion for costs of doing business. *See* Unfair Sales Act, Wis. Stat. § 100.30.
38 Evans, *supra* note 14, at 1059; *State v. Wender*, 141 S.E.2d 359 (W. Va. 1965); *Rabren v. City Wholesale Grocery Co.*, 266 So. 2d 882 (Ala. 1972).
39 Evans, *supra* note 14, at 1059.
40 *Id.* at 1061.
41 *See, e.g., Oil Well Co. v. Ala. State Dept. of Revenue*, 350 F. Supp 416 (M.D. Ala. 1971).
42 *Id.*
43 *Staples v. U.S.*, 511 U.S. 600, 639 (1994).
44 *See id.*
45 Wirth, *supra* note 4, § 4.
46 *Id.*
47 *See, e.g., State ex rel. O'Connell v. Albertson's Inc*, 68 Wash 2d 274 (1966)
48 *See, e.g., Co-Opportunities, Inc. v. Nat'l Broad. Co.*, 510 F. Supp 43 (N. D. Cal. 1981) (determining under California law that the practice of providing free co-op services to defendant's affiliates did not constitute a sale subject to the below-cost regulation); *See also Dir. of Div. of Milk Ctrl. v. Haseotes*, 220 N.E. 2d 910 (Mass. 1966); *Ivan's Tire Serv. Store, Inc. v. Goodyear Tire & Rubber Co.*, 546 P.2d 109 (Wash. 1976).
49 *Id.*
50 This scheme would work similarly to the first method of profiting from below cost selling described on page 83. *See* Morgan, *supra* note 2, at 1.A.; Wirth, *supra* note 4, § 2.
51 *Id.*
52 Wirth, *supra* note 4, § 9, 10 & 11.

53 *State ex rel. Galanos v. Mapco Petroleum, Inc.*, 519 So.2d 1275, 1284 (Ala. 1987).
54 *See, e.g., Drink, Inc. v. Babcock*, 421 P.2d 798 (NM 1966); *Wiley v. Sampson-Ripley Co.*, 120 A.2d 289 (ME 1956).
55 *Drink Inc.*, 421 P.2d at 803.
56 *Id.*
57 *Id.* at 802.
58 *Id.* (citing *State ex rel. Newman v. City of Laramie*, 275 P. 106 (Wyo. 1929) and *City of Alexandria v. Hall*, 131 So. 722 (La. 1930).
59 *Galanos*, 519 So.2d at 1287.
60 *Id.*
61 *Id.*
62 *Id.*
63 *Id.*
64 *See Commonwealth v. Zasloff*, 13 A.2d 67 (Pa. 1940); *Anderson v. Fleming Co.,* 339 P.2d 12 (Kan. 1959).
65 Francis M. Dougherty, *Validity, construction, and application of state statutory provision prohibiting sales of commodities below cost—modern cases*, AMERICAN LAW REPORTS, 41 A.L.R.4th 612, §5 (1985).
66 *See Zasloff*, 13 A2d at 71.
67 *See, e.g., Remote Services Inc v. FDR Corp.*, 764 S.W.2d 80 (Ky. 1989)
68 *Strickland v. Ports Petroleum Co., Inc.*, 353 S.E.2d 17 (Ga. 1987).
69 *Id.*