THE LAW ON PREDATORY PRICING IN CALIFORNIA

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I. Introduction

One of the areas of modern antitrust analysis that has been greatly influenced by the neoclassical economic paradigm, especially Alfred Marshall's marginalism, is predatory pricing under section 2 of the Sherman Act. Federal antitrust law under section 2 of the Sherman Act takes an objective cost approach as a first step in determining if price cutting can be deemed predatory. Unlike federal antitrust jurisprudence which derives its authority from the broadly drafted Sherman Act and is based primarily on federal common law, the California Legislature enacted a more sophisticated statutory scheme to deal with predatory pricing known as the Unfair Practices Act.[1]

Just over ten years ago, the California Supreme Court had the opportunity to clarify the manner in which below cost pricing under the Unfair Practices Act could be determined under an objective cost based approach as it is in the federal judiciary pursuant to section 2 of the Sherman Act. The case of *CelTech Communications, Inc. v. Los Angeles Cellular Telephone Company* was that opportunity.[2]

This article sets out to review the development of the modern approach to predatory pricing under the Sherman Act. It will then assess the California Supreme Court's ruling on the Unfair Practices Act portion of the *CelTech* opinion, including the scathing dissent authored by Associate Justice Marvin Baxter. Finally, a brief look at the published law that has come after *CelTech* will be surveyed.

II. Predatory Pricing Under Section 2 of the Sherman Act

A. United States Supreme Court Decisions On Predatory Pricing

At first blush, the notion of lower prices as a method of harming consumers seems to be a questionable proposition. However, as experience has shown, there are situations where prices can be lowered to such an extent that a monopoly or threat of a monopoly results in the relevant product market. However, in order to avoid the notion that a business can fall under the sledge hammer of treble damages for lowering prices on goods, the Supreme Court has gone about establishing clear guidelines on when such conduct is to be deemed predatory and therefore warranting monetary damages under the Sherman Act. The Supreme Court has held that:

> Predatory pricing may be defined as pricing below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run. It is a practice that harms both

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1 Cal.Bus.&Prof.Code §17000, *et seq*.

2 20 Cal.4th 163 (1999).

> competitors *and* competition. In contrast to price cutting aimed simply at increasing market share, predatory pricing has as its aim the elimination of competition.[3]

What the Court had done was to move away from the notion that lowering the price on goods would be evaluated negatively under the federal antitrust laws when in the vast majority of circumstances, lowering prices benefits consumers. In order for price cutting to be predatory, pricing must be below an objective cost level and be sustained for such a duration that it not only eliminates competitors, but also harms competition.

After allowing the *Cargill, Inc.* decision to percolate in the district and appellate courts for several years, the United States Supreme Court finally decided to establish a clear, objective cost criteria in determining whether pricecutting behavior would be deemed predatory under the antitrust laws. In *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.,*[4] the Court set out the test for determining the existence of predatory pricing. The predatory pricing analysis is a two-prong test and is as follows:

> First, a plaintiff seeking to establish competitive injury resulting from a rival's low prices must prove that the prices complained of are below an appropriate measure of its rival's costs. . . The second prerequisite . . .is a demonstration that the competitor had a reasonable prospect, or under§ 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices.[5]

The Court explained the rationale for the two-prong analysis. As to the cost prong, the Court held that any "exclusionary effects of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator . . .or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting."[6] The Court wanted to steer clear of having to evaluate every price cutting effort that can be viewed by a competitor as predatory, that may in fact be providing a benefit to consumers.

The recoupment prong is based on the rationale that the pricecutter would only be operating in a predatory manner if it could successfully run its competitors out of business and obtain monopoly profits. "'For the investment to be rational, the [predator] must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered.'"[7] For a predatory pricing scheme to be successful, recoupment is the ultimate goal. "Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced."[8] It does not matter that a competitor may be hurt by the

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3 *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117-118 (1986)

4 509 U.S. 209 (1993)

5 *Id.* at 222-224. Although *Brooke Group* was a primary line Robinson-Patman Act action, the Supreme Court indicated that the same analysis applies in a predatory pricing case under section 2 of the Sherman Act. See *Brooke Group*, supra, 509 U.S. at 222.

6 *Id.* at 223.

7 *Id.* at 224, quoting *Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588-589 (1986).

8 *Id.* at 224.

price-cutting, harm to competition (e.g. consumers) must be proven.

The Supreme Court has recognized that this two-prong analysis will make proving predatory pricing an extremely difficult endeavor for the trial lawyer. "[P]redatory pricing schemes are rarely tried, and even more rarely successful."[9] The Court indicated that the standards for finding predatory pricing liability are high because the mechanism of lowering prices in a predatory setting is the same action that is undertaken to stimulate competition. To make mistaken judicial inferences would be costly as "they [would] chill the very conduct the antitrust laws are designed to protect."[10]

B. Relevant Measure Of Costs

Although not completely uniform in all federal circuits as to what the appropriate measure of cost is in establishing pricecutting behavior as predatory, the courts, for the most part, have taken some sort of objective cost basis in conducting the analysis. Modern antitrust law related to predatory pricing based on an objective marginal or average cost analysis derives from the authors Phillip Areeda & Donald Turner ("Areeda & Turner") in their article "*Predatory Pricing and Related Practices Under Section 2 of the Sherman Act.*"[11] Areeda & Turner argue that a rational business, being a profit-maximizing entity, will seek to attract more business by lowering its prices and attracting more consumers. Under a highly competitive market, the invisible hand will guide prices towards the level of cost[12]. If the entity sells its products below cost, such conduct would be deemed irrational for the profit-maximizing actor, and it would be reasonable to presume a motive other than competition on the merits.[13]

Many federal circuit courts use either average variable costs or average total costs as the appropriate measure of cost in conducting a predatory pricing analysis.[14] In the Ninth Circuit, a "plaintiff has established a prima facie case of predatory pricing and the burden shifts to the defendant to prove that the prices were justified without regard to any anticipated destructive effect they might have on competitors."[15] If however, the price is above average variable cost but below average total cost, the plaintiff bears the burden of showing defendant's pricing

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9 *Matsushita*, supra, 475 U.S. at 589.

10 *Cargill, Inc.*, supra, 479 U.S. at 122, n. 17.

11 88 Harv.L.Rev. 697 (1975). See also *Brooke Group, Ltd.*, supra, 509 U.S. at 221, 222, 225; *CelTech Communications*, supra, 20 Cal.4th 163, 222 (J. Baxter dissenting).

12 Such an assumption is extremely suspect under an oligopoly market structure.

13 There may be times where selling under one's average total cost may be reasonable.

14 Average variable cost is the cost of those inputs that vary with output divided by the number of total units. See *William Inglis, Etc. v. ITT Continental Baking Co.* (9th Cir. 1981) 668 F.2d 1014, 1035. Average fixed costs are the sunk costs separate and apart from the variable input costs divided by the number of unit products. Average total cost is the sum of the average fixed costs plus the average variable costs.

15 *William Inglis, Etc. v. ITT Continental Baking Co.* (9th Cir. 1981) 668 F.2d 1014, 1036. See also *Vollrath Co. v Sammi Corp.* (9th Cir. 1993) 9 F.3d 1455, 1460-1462.

was predatory.[16] Other circuits that have adopted a cost test have adopted the bench mark as average variable cost or a hybrid version of the Ninth Circuit test.[17]

III. Predatory Pricing Under California Law

California enacted the Unfair Practices Act ("UPA") "to safeguard the public against the creation or perpetuation of monopolies and to foster and encourage competition, by prohibiting unfair, dishonest, deceptive, destructive, fraudulent and discriminatory practices by which fair and honest competition is destroyed or prevented."[18] The UPA covers both products and services, in contrast to products only under the RobinsonPatman Act.[19] The UPA functions as the California state version of the Sherman Act section 2 for predatory pricing as well as the price discrimination analysis under the RobinsonPatman Act.

As it relates to predatory pricing, the UPA makes it "unlawful for any person engaged in business within this State to sell any article or product at less than the cost thereof to such vendor . . .for the purpose of injuring competitors or destroying competition."[20] As if foreseeing Areeda & Turner's article back in 1941, the California Legislature defined "cost" as "the cost of raw materials, labor and all overhead expenses of the producer."[21] Similar to the Ninth Circuit's analysis of presumption associated with cost, the UPA presumes "evidence of the purpose or intent to injure competitors or destroy competition . . .[if a] product [is sold] below cost . . .together with proof of the injurious effect."[22] The statutory scheme under the UPA appears to have the cost prong of *Brooke Group* codified, but not the recoupment portion. However, an argument can be made that in order to demonstrate an "injurious effect," a party must establish the recoupment prong.

A. The *CelTech Communications* Decision

The California Supreme Court had the opportunity of providing a modernized interpretation to the UPA in the case of *CelTech Communications, Inc. v. Los Angeles Cellular Telephone Co.*[23] The basic facts of the case were that L.A. Cellular was one of two companies licensed by the federal government to provide cellular telephone service in the Los Angeles area. In addition to proving cellular services, L.A. Cellular also sold cellular telephones. The plaintiffs in the action, including CelTech Communications, sold cellular telephones in the Los Angeles area only, as they were not licensed to sell cellular service. In order for L.A. Cellular to increase more subscribers for its phone service, it began selling cellular telephones at below cost.

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16 *Id.* at 1035-1036.

17 See *TriState Rubbish v. Waste Management* (1st Cir. 1993) 998 F.2d 1073, 1080; *Kelco Disposal v. Brown-Ferris Industries* (2d Cir. 1988) 845 F.2d 404,407, aff'd on other grounds, 492 U.S. 257 (1989).

18 Cal.Bus.&Prof.Code §17001.

19 Cal.Bus.&Prof.Code §17024.

20 Cal.Bus.&Prof.Code §17043.

21 Cal.Bus.&Prof.Code §17026. This definition of costs is akin to average total cost as it includes "all overhead expenses."

22 Cal.Bus.&Prof.Code §17071.

23 20 Cal.4th 163.

The plaintiffs brought forth an action under several causes of action, including the UPA and the Unfair Competition Law ("UCL").[24] The UPA claim alleged unlawful engagement in below cost pricing and the use of loss leaders. After the close of plaintiffs evidence, L.A. Cellular brought a motion for judgment. The Court granted the motion on the basis that even though below cost pricing and injury to the plaintiffs was shown, the plaintiffs failed to demonstrate an intent to harm them by L.A. Cellular, rather than L.A. Cellular's effort to compete with the other cellular service provider in Los Angeles.[25] The trial court also ruled that the UCL claim also necessarily failed for the same reason. On appeal, the Second District upheld the decision as to all aspects of the lower court's decision except for its ruling on the UCL claim, and remanded this portion of the case to be retried. The California Supreme Court took up review on both issues.

B. *CelTech*'s UPA Analysis

The majority in *CelTech* was left with the question of how to interpret the word "purpose" under both sections 17043 (below cost pricing) and 17044 (loss leaders) of the Business and Professions Code. The Court of Appeals held that the term "purpose" meant that the alleged predator had to have a "specific intent to injure competitors or destroy competition."[26]

The California Supreme Court framed the inquiry they were facing in this way:

> whether the statute requires the desire to injure competitors or destroy competition or only knowledge that the injury or destruction will occur.[27]

Given the lack of case law interpreting section 17043, the Court looked to the Model Penal Code and the Restatement of Torts. In looking to the Model Penal Code, the word, "purpose" was found to have a precise meaning essentially equating to the actor 's "conscious object."[28] In looking to the comment section to the Model Penal Code, the Court noted the difference of culpability between the terms "purposely" and "knowingly." Both terms have the knowledge element, but knowledge will not be deemed purposeful unless "it is his conscious object to perform an action of that nature or to cause such a result."[29]

The Court then drew its attention to the Restatement of Torts to support the distinction between the two forms of culpability. Although not as clear a distinction between the terms "knowledge" and "purpose" exists in the Restatement of Torts, the Court explored section 870 of the Restatement Second of Torts. The Court found that the term purpose was used, but not defined, several times in its discussions of intent and knowledge. Based on the use of the term "purpose," the Court held that the Restatement "shows an awareness of the precise

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24 Cal.Bus.&Prof.Code §17200.

25 *CelTech Communications, Inc.*, supra, 20 Cal.4th at 170.

26 *Id.* at 172.

27 *Ibid.*

28 *Id.* at 173.

29 *Ibid.*, quoting *Model Pen. Code & Commentaries*, com. 2 to §2.02, p. 233, fn. omitted.

meaning of the word 'purpose'."[30]

The Court also looked at the long standing interpretations of the term "purpose" held by appellate courts interpreting section 17044 (loss leaders). The majority focused on dicta from the case of *TriQ, Inc. v. StaHi Corp*, where the Supreme Court adopted the reasoning of the appellate court.[31] The trial court in *TriQ* found that the defendant did not sell below cost. The Court of Appeal further went on to state "[b]ut even had the trial court found that the product had been sold below cost, there would still be the issue of whether the seller had so acted 'for the purpose of injuring competitors or destroying competition.'"[32]

Taking this dicta, which did not define what the term "purpose" meant, the majority held that since Legislature had not amended the statute to define the term differently for over three decades, it was not either. The Court indicated that "it is up to the Legislature to change it if it is to be changed."[33]

Based on a strict interpretation of the statutory language, the Court held that the term "purpose" meant that the alleged predator must act with the "desire" of injuring competitors or destroying competition.[34] In defining whether a market player should be held liable under the UPA's below cost pricing statute, a finding of subjective intent must be shown.

C. Justice Baxter's Dissent

In an eighteen page dissent, Associate Justice Marvin Baxter challenged the majority's narrow interpretation of the term "purpose." Justice Baxter took three distinct and independent analysis in interpreting section 17043: 1) the entire statutory scheme of the UPA; 2) the statutory presumption set out in section 17071; and 3) modern economic thought in conjunction with federal legal interpretation of predatory pricing under section 2 of the Sherman Act.

1. UPA's Statutory Scheme

Justice Baxter took on the task of understanding the UPA in its entirety. First, the UPA is to be *liberally* construed.[35] He then indicated that a canon of statutory interpretation is to construe a particular statute "with regard to the statutory scheme of which it is a part . . ."[36] The dissent goes on to describe the many different sections in the UPA where the terms "intent" and "purpose" are used interchangeably.[37]

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30 *CelTech*, supra, 20 Cal.4th at 174.

31 63 Cal.2d 199, 203 (1965).

32 *CelTech*, supra, 20 Cal.4th at 177; quoting *TriQ*, supra at 207.

33 *Id*. at 178.

34 *Id*. at 175.

35 Cal.Bus.&Prof.Code §17002.

36 *CelTech*, supra, 20 Cal.4th at 210 (J. Baxter dissenting); citing *Briggs v. Eden Council for Hope & Opportunity* (1999) 19 Cal.4th 1106, 1118.

37 *Ibid*.

However, section 17071 is the most convincing portion of the dissent. Section 17071 states:

> In all actions brought under this chapter proof of one or more acts of selling or giving away any article or product below cost or at discriminatory prices, together with proof the injurious effect of such acts, is presumptive evidence of the purpose or intent to injure competitors or destroy competition.[38]

The dissent further points out that under the UPA, an agent of a principal could be faced with an injunction and/or criminal prosecution for violating the below cost pricing statute based on proof of unlawful *intent*, as opposed to unlawful *purpose*.[39] Both sections 17096 and 17101 both provide for either criminal liability or an injunction of an officer, director or agent if one is able to prove "the unlawful intent of the person, firm or corporation for which he acts."[40] Justice Baxter points out that it would make no sense to absolve the principal that acted with the knowledge or had reason to know the injurious effect of below cost pricing, "but impose liability on an agent of the principal" on the same grounds.[41]

2. Presumption of Purpose or Intent

The dissent by Justice Baxter next goes on to discuss the statutory presumption created by the UPA under section 17071. As the dissent indicated, short of finding a "smoking gun" memorandum or an email showing the subjective intent of the below cost seller's subjective intent to injure competitors or destroy competition, "proof of such intent or purpose is well nigh impossible to come by."[42] Justice Baxter argues that this is the legislative reason why the presumption of intent or purpose was created if the plaintiff can demonstrate below cost sales and injurious effect.

Section 17050 sets out specified exclusions to when below cost sales are deemed permissible. These include the closing out the owner's stock, sale of damaged goods, and "an endeavor made in good faith to meet the legal prices of a competitor selling the same article. . ."[43] The dissent points out that the majority "assumes without discussion that section 17050 is not the exclusive means by which a defendant may rebut the presumption of section 17071 and establish the absence of intent or purpose to injure or destroy competition.[44]" By doing so, the dissent argues that by ignoring the presumption established in section 17071 and interpreting section 17043 as it has, section 17050 has been rendered nugatory.[45] Ultimately, Justice Baxter argues that the majority's decision stands for the proposition that "[a]s long as a below-cost seller intends no evil, it is free to wreak havoc on the competitive

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38 Cal.Bus.&Prof.Code §17071.

39 *CelTech*, supra, at 211-212.

40 Cal.Bus.&Prof.Code §§17096; 17101.

41 *CelTech*, supra, at 212.

42 *Id.* at 213.

43 Cal.Bus.&Prof.Code §17050.

44 *CelTech,* supra, 20 Cal.4th at 214 (J. Baxter, dissenting).

45 *Id.* at 216.

market for the product it sells below cost regardless of its knowledge of the impact of its action on other sellers . . ."[46]

3. Reconciling Federal And State Predatory Pricing Doctrines

Justice Baxter took his dissent one ambitious step further than the majority, he sought to see whether or not below cost pricing under the UPA can be aligned with the predatory pricing analysis undertaken pursuant to section 2 of the Sherman Act. The dissent goes into a discussion of the modern economic analysis of predatory pricing in federal antitrust law, citing *Brooke Group*, *Matsushita*, and *Atlantic Richfield*. Furthermore, the dissent cites to Areeda & Turner's seminal article on predatory pricing, as well as Professor James McCall's article on the UPA.[47] As Professor McCall noted in his 1997 article, the concept of intent to injure has decreased in importance over the past 20 years.[48]

Justice Baxter explained why the decline in importance of specific intent to injure was the trend in competition law. He stated that "[r]equiring proof of subjective intent to injure competitors . . .is not appropriate in the competitive business arena [because] 'cutting prices in order to increase business often is the very essence of competition.' *Matsushita Elec. Industrial Co. v. Zenith Radio* (1986) 475 U.S. 574, 594."[49] Adopting the rationale from Areeda & Turner, Justice Baxter went on to explain how the majority's interpretation of subjective intent makes little sense.

> Any price cut which attracts a consumer who would have gone to another seller, harms the seller that did not make the sale. Evidence that the belowcost seller did not intend to injure is meaningless. To intend to compete through below-cost sales is, necessarily, to intend to injure a competitor. For this reason the UPA does not require proof of intent to injure, but instead presumes that intent exists for purposes of section 17043 and 17044 when a business engages in below-cost selling.
>
> Modern economic theory assumes that a business with prices lower than those of its competitors intends harm to the competitors insofar as it is able to attract customers who would otherwise trade with the competitors. Since this behavior stimulates competition it benefits consumers. Therefore, it is inappropriate to import into antitrust law the criminal law concept of intent or purpose to cause injury as a state of mind warranting punishment. Subdivision (d) of section 17050 demonstrates that the California Legislature did not intend to do so. Antitrust law encourages the state of mind of beating competitors through lower prices because, to a certain point, consumers benefit. It is only when '[a] firm . . .drives out or excludes rivals by selling at unremunerative prices [that it] is

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46 *Ibid*.

47 *Id*. at 221, fn. 9; 222.

48 McCall, *Private Enforcement of Predatory Price Laws Under the California Unlawful Practices Act and the Federal Antitrust Acts* (1997) 28 Pacific L.J. 311, 331.

49 *CelTech*, supra, at 223 (J. Baxter, dissenting).

not competing on the merits, but engaging in behavior that may properly be called predatory.' [Citation omitted]"[50]

Justice Baxter was concerned about providing, as much as possible, uniformity between California antitrust law and federal antitrust law.[51] As the associate justice explained, "[u]niformity benefits both the business community and the consumers for whose protection these laws were enacted."[52] Unfortunately, the majority failed to seize this opportunity.

IV. Section 17043 Post*CelTech*

The *CelTech* decision has placed a high, subjective intent hurdle on UPA below cost pricing actions, making it much more difficult to achieve its statutory purpose. There has been a dearth of published decisions related to the UPA post-*CelTech*. The Ninth Circuit has recently upheld a dismissal of a case under section 17043 for failure of the plaintiff to allege that a particular below cost price cutter's intent was to specifically injure the plaintiff rather than harm to competition in general.[53] The First District Court of Appeals overruled summary adjudication related to a predatory pricing claim based on the existence of triable issues of facts on the issue of specific intent.[54] It is not clear whether the low level of published cases dealing with section 17043 is a result of the specific intent standard placed on UPA below cost pricing cases or whether there is a low level of alleged violations. However, predatory pricing cases under section 2 of the Sherman Act are still actively filed, both in California and in other states.

V. Closing Remarks

In order to obtain the benefit of assessing predatory pricing from the standpoint of an "appropriate measure" of costs and make California's Unfair Practices Act relevant again, one of two things needs to occur. The first is that the California Supreme Court would (and should) take a renewed look at the Unfair Practices Law and assess the "purpose" requirement under the presumption set forth under section 17071. Given the unlikelihood of this, the only other alternative to make the Unfair Practices Law's below cost pricing statute relevant again in protecting California consumers is to have the California Legislature amend the statute to alter the meaning of the "purpose" requirement to conform with the objective standards applied under section 2 of the Sherman Act.

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50 *CelTech*, supra, 20 Cal.4th at 223-224 (J. Baxter, dissenting).

51 *Id*. at 223-224.

52 *Id*. at 224.

53 *Sybersound Records, Inc. v. UAV Corp*. (9th Cir. 2008) 517 F.3d 1137, 1153-1154.

54 *Fisherman's Wharf Bay Cruise Corp. v. Superior Court* (2003) 114 Cal.App.4th 309, 321-330.