



# PRICE DISCRIMINATION AND THE LAW

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When making pricing decisions, the successful strategist must consider not only what is profitable, but is lawful. Unfortunately, good advice on this issue is all too often misleading. Attorneys who do not specialize in antitrust law tend to be overly conservative—advising against activities that are only sometimes illegal or that could trigger an investigation. On the other hand, product and sales managers eager to achieve quarterly objectives will sometimes fail to consider these constraints at all, resulting in costly condemnations of their companies in courts of law or public opinion.

Since the late nineteenth century, the United States has been committed to maintaining price competition through establishing and enforcing antitrust policy. U.S. law on this issue has focused on maintaining the viability of numerous sellers as a means to preserve competition. Consequently, while price discrimination has been unlawful since 1914, the Robinson-Patman Act amended existing legislation in 1936, so this entire area is commonly referred to by the name of the amendment.

This complex, Depression-era legislation was enacted to protect small businesses

by outlawing discriminatory price and promotional allowances obtained by large businesses. As is the case with the other antitrust laws, the Department of Justice, the FTC, and private parties may each bring Robinson-Patman cases, although the enforcement agencies have not focused on this area for some time. Indeed, the Justice Department has criminal powers in this area that have gone unused for many years, while the FTC today brings few significant cases in this area after being particularly active through the 1970s. Private suits on behalf of businesses (consumers have no standing to sue under the statute) account for most of the enforcement activity. Successful plaintiffs are entitled to the same remedies as those available under the antitrust laws (e.g. injunctions, treble damages, attorneys' fees and costs).

## **Illegal Price Discrimination**

Keep in mind that discrimination in price is not always unlawful. In order to prove illegal price discrimination under the Robinson-Patman Act and assuming that the supplier sells in interstate commerce, each of five elements must be present.

1. Discrimination -This standard is met simply by charging different prices to

different customers. However, if the reason for the difference is due to a discount or allowance made available to all or almost all customers (like a prompt payment discount), but some customers choose not to take advantage of it, the element of discrimination drops out.

2. Sales to Two or More Purchasers - The different prices must be charged on reasonably contemporaneous sales to two or more purchasers—a rule that permits price fluctuations. In other words, it is inappropriate under the statute to compare two widely separated sales in a highly volatile market. Yet if prices typically change annually or semiannually, a sale made in January may be compared with one made in March. In addition, offering different prices is not enough. Actual sales or agreements to sell at different prices must exist. For example, if two electrical supply distributors seek special pricing from the manufacturer to bid on a construction job or an integrated supply contract that only one will get, the manufacturer may, if it is careful, give one a better price than the other, because in doing so, it is providing two offers, but making only one sale.

3. Goods - Robinson-Patman applies to the sale of goods only (“commodities” in the statute), so services—such as telecommunications, banking, and transportation—are not covered. When a supplier sells a bundled offering, such as repair services that include parts or computer hardware that includes maintenance services, Robinson-Patman is relevant only if the value of the goods in the bundle predominates. Also, it is possible to turn goods into services if the manufacturer procures raw materials and produces and stores the products on

behalf of the customer, with the customer owning the inventory every step of the way and bearing the risk of loss.

4. Like Grade and Quality - The goods involved must be physically or essentially the same. Brand preferences are irrelevant, but functional variations can differentiate products. In a key case, the Supreme Court stated that a branded product and its physically and chemically identical private-label version must be priced the same by the manufacturer. While the distinctions drawn in the case law sometimes appear arbitrary, meaningful functional or physical variations can result in different products that legitimize different prices. For example, two air conditioners that have significant differences in cooling capacity are distinct products, even if they otherwise are physically identical.

5. Reasonable Probability of Competitive Injury - The law generally focuses on injury at one of two levels. The first, called “primary line,” permits a supplier to sue a competitor for the latter’s discriminatory pricing. But here the law also requires that the supplier’s discriminatory pricing be below its cost, something designed to drive its rival out of business or otherwise injure competition in the market as a whole (called “predatory intent”), rather than to merely take some incremental market share. Moreover, the structure of the market must be such that the discriminating supplier can raise prices after it disposes of the targeted competitor or that market injury otherwise is threatened through reduced output. Not surprisingly, there are few contemporary primary-line cases due to this tough standard.

Far more common is “secondary line” injury, where a supplier’s disfavored reseller or end-user customer may sue the supplier for price discrimination. However, the law is clear that only competing customers must be treated alike. To the extent that customers do not compete due to their locations or the markets they serve, different prices are appropriate under the Robinson-Patman Act. Significantly, if these distinctions do not occur naturally, they may be introduced or formalized by contract or policy through the use of vertical nonprice restrictions.

### **Defenses to Price Discrimination**

Even if all five price-discrimination elements are present, there are three defenses that may be used to avoid what otherwise is unlawful discrimination.

1. Cost Justification - This defense permits a price disparity if it is based on legitimate cost differences. For example, freight is usually less expensive on a per-case basis for a truckload shipment. However, while there is no requirement to pass on any savings, if the supplier does so, the law states that some or all of the actual savings may be passed on to the customer, but not a penny more.

One common problem area is volume discounts, particularly those that are stair-stepped with large differences between levels. Perhaps this structure reflected real cost differences many years ago when it was adopted by the supplier, but, unless the underlying cost analysis is regularly updated, the discounts probably do not track today’s costs. Indeed, the dynamic nature of business and the precision required to support this defense make it difficult to

apply successfully, although the sophistication of activity-based costing holds a great deal of potential. Some manufacturers keep profit-and-loss statements on their customers and adjust their pricing accordingly.

2. Meeting Competition - Under this defense, discrimination is permissible if it is based on a good-faith belief that a discriminatory price is necessary to meet the price of a competitive supplier to the favored customer or to maintain a traditional price disparity. Most managers are familiar with the application of this defense on the micro level, that is, when a buyer tells the seller that the seller’s competitor offered a lower price. However, meeting competition may also be used on the macro level to justify things like volume discounts that are so institutionalized in the industry that adjusting them to reflect true cost savings would result in the loss of business.

Of course, it is at the micro level where this defense is most often used. Unfortunately, this means relying on the purchaser for competitive pricing information when the buyer has every incentive to lie. Some companies provide their salespeople with detailed meeting-competition forms that require competitive invoices and other documentary evidence. While this sort of evidence is helpful, it is not essential, as long as the seller has a reasonable basis at the time of the decision to believe that the competitive price described by the buyer is legitimate, even if it turns out to be wrong later. Nevertheless, a written or electronic record of why the otherwise discriminatory price was provided is useful.

Because meeting competition is a defense, there is no obligation to provide the special price to anyone other than the customer that asked for it. Of course, smart buyers will attempt to secure “most favored nations” clauses in their contracts or purchase orders to automatically get the benefit of a lower price elsewhere, regardless of whether they would otherwise be entitled to them. Such clauses may cause tension between a supplier’s Robinson-Patman responsibilities and those under the law of contract.

3. Changing Conditions - Special prices may be provided to sell perishable, seasonal, obsolete, or distressed merchandise, even though the full price had been charged up to the point of offering the special prices.

### **Summary**

The development and implementation of pricing strategies and tactics that do not violate the law is an important aspect of pricing. In addition to the risk of legal actions initiated by the government, a company can be sued by private parties, usually its competitors or its customers. If the Justice Department can prove that the company’s pricing violated the criminal provisions of the antitrust laws, the company is subject to fines and its managers may face both fines and imprisonment. Even if antitrust claims are successfully defended, their defense is usually disruptive to the business and expensive in terms of monetary and management costs, as well as the effects on reputation. At the same time, it is obvious that the law is rarely black and white, particularly in the area of pricing. Over the last several decades, U.S. courts have placed more emphasis on showing demonstrable economic effect,

rather than relying on assumptions to find antitrust violations. Indeed, once the business objectives are clear, contemporary antitrust law provides considerable flexibility to develop alternative strategies and tactics, which are usually compatible with the degree of legal and trade-relations risk a business wishes to assume. While there often are no easy answers, in most cases the ends are achievable with some modification of the means.



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