IN THE COURTS

LOSS MINIMIZING SELLER ACQUITTED OF PREDATORY PRICING CHARGE

The Supreme Court of Ontario, in a judgment by Mr. Justice O'Leary on June 17, 1981, acquitted a parent company and its subsidiary on a count under s. 34(1)(c) of the Combines Investigation Act, finding that the accused sold below full cost in an effort to minimize losses or maximize profits rather than to eliminate a competitor (R. v. Consumers Class Company Limited and Portion Packaging Limited).

S. 34(1)(c) prohibits anyone engaged in a business from engaging in "a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such an effect".

Portion, a wholly owned subsidiary of Consumers Glass, was until 1975 the sole Canadian manufacturer selling small plastic lids to five Canadian manufacturers of plastic cups not making their own lids. It also made some sales of the lids abroad and produced a wide range of other plastic products. In August 1975, Amhil Enterprises Ltd., which had been established by former senior employees of Portion, entered the market for small lids in competition with Portion. At the time the total Canadian non-captive market was only equivalent to about 70 percent of Portion's capacity, and Amhil's capacity was about the same as Portion's. Even before the entry of Amhil, lid prices were low in relation to costs because customers were in a position to import lids or else to purchase the specialized lid forming equipment for about $200,000.00. Portion had already set in motion plans to develop alternative products and to vacate the lid market gradually, and by 1979 had dropped completely out of the small and large custom lid market.

Amhil priced its lids two to three percentage points below Portion's. In October 1975, Portion lowered its prices by up to 16 percent depending upon quantities. Amhil lowered all its prices to the lowest Portion price. Portion met Amhil's new price. In December 1976 Portion offered customers a further five percent discount if they purchased all their requirements from Portion. By the end of 1976 Portion's share of the market had declined from 100 percent to about 60 percent. In 1977 Portion considered a price increase but decided against it because of the twin threats of losing more business to Amhil and to captive operations. By February 1978 Portion's market share had declined to about thirty percent, partly because it had begun producing plastic cups and its customers came to regard it as a competitor. In that month Amhil raised its prices by ten percent but Portion did not follow. Amhil operated at a loss

during the relevant period. Portion, after its 16 percent price decrease in 1975, was selling lids at below total cost but above average variable cost.

The Crown alleged that the defendants sold the lids at prices substantially below total cost of producing and selling in an effort to drive Amhil out of business.

O'Leary, J. made the following comments about s. 34(1)(c):

"The Act does not specifically define what constitutes an unreasonably low price. In deciding whether a price is unreasonably low, the Court should bear in mind that the purpose of the Act is to protect the public interest in free competition, and that section 34(1)(c) of the Act prohibits predatory pricing, that is to say, the selling at low prices for anti-competitive purposes... the classic example of predation runs as follows:

(1) The predator deliberately sacrifices present returns by lowering the selling price for the purpose of driving rivals out of the market.
(2) The rivals, having less financial staying power than the predator, are driven out of the market.
(3) In the absence of competition the predator raises its prices so as to recover the sacrificed returns and earn higher profits.

. . . . .

"The whole object of competition is to maximize profits by taking as much business as possible away from rivals, and so the mere fact one competitor lowers prices so as to take business from a rival to the point that the rival might be forced from the marketplace cannot, by itself, determine whether predatory pricing was involved."

O'Leary, J. took into account the expert testimony of defence witness Donald F. Turner, and of Crown witness Douglas F. Greer. Dr. Turner's evidence reflected an article written by Phillip Areeda and himself entitled "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act" (88 Harvard Law Review 697-733, 1975). Dr. Turner's position was that pricing by a monopolist at or above marginal cost should be tolerated but pricing below marginal cost should not. Marginal cost is the increment to total cost that results from producing an additional increment of output. Since marginal costs are frequently not ascertainable, he suggested that average variable cost would be a useful surrogate for pricing analysis, even though it might differ from marginal cost. He defined variable cost as "costs that vary with changes in output... The average variable cost is the sum of all variable costs divided by output." His article concluded:

> "2. Recognizing that marginal cost data are typically unavailable, we conclude that:
> a) A price above reasonably anticipated average variable cost should be conclusively presumed lawful.
> b) A price below reasonably anticipated average variable cost should be conclusively presumed unlawful."

Dr. Greer's evidence reflected his article, "A Critique of Areeda and Turner's Standard for Predatory Practices" (Antitrust Bulletin, Summer, 1979). Dr. Greer agreed with Dr. Turner that those selling below average variable cost are almost certainly predators. However, he took the position that there may also be predation where sales are above average variable cost but below average total cost. In such cases, he argued that evidence of intent should be taken into account. He stated in his article:

> "...I conclude that the Areeda-Turner standard is much too limited when compared to a broader and more traditional standard comprised of (1) pricing below total average cost and (2) substantial evidence of predatory intent... (1) Intent can be shown by a wide variety of other economic and non-economic evidence besides pricing below marginal or average variable cost, and (2) this evidence of intent ought to be admissable in court as establishing predation when coupled with proof of pricing below average total cost."

Mr. Justice O'Leary noted that both witnesses took the view that there is no predation when a seller is loss-minimizing in the short run. A sale at anything above marginal cost contributes something to overhead and, depending upon the circumstances, may be the price which minimizes losses or maximizes profits. Thus, the Areeda and Turner article states:

> "The firm that is selling at a shortrun profit maximizing (or loss-minimizing) price is clearly not a predator. A necessary... condition of predation is the sacrifice of shortrun profits."

And the Greer article states:

> "...A predator, by definition, does not aim to maximize short-run profits or minimize short-run losses by manipulating short-run cost and revenue. A predator operates strategically in the long run."

After noting the foregoing, O'Leary, J. said:

> "If Drs. Greer and Turner are correct, that there can be no predation while an accused is loss-minimizing, and I believe they are, then the accused in this case never sold at predatory, that is to say unreasonably low, prices, because at all times they were selling so as to make the greatest contribution to Portion's fixed overhead."

O'Leary, J. also noted that, while United States courts have generally accepted the Areeda and Turner proposal, it was not accepted in Transamerica Computer Co. v. IBM Corp., 1979, 2 Trade Cases, 79618. In that case the Court disagreed that an unprofitable price must be presumed to be legal merely because it is above marginal cost. Nevertheless, the Court in that case stated:

> "...prices below average cost would be warranted if shrinking demand forced the monopolist to minimize its losses by selling at the best price-cost relationship available to it, or where the industry suffers from chronic excess capacity."

And Mr. Justice O'Leary commented:

> "Both such conditions existed in the case before me. Because of the entry of Amhil into the small lid market, the demand for the small lids made by Portion shrank and excess production capacity became chronic. In these circumstances Portion could only minimize its losses (and that it did do) by selling below average total cost. By so doing it was selling at a reasonable non-predatory price."

Mr. Justice O'Leary, after considering evidence presented by the Crown in support of its allegation that Portion had sought to drive Amhil out of business, stated:

> "I conclude therefore that Portion instituted and pursued a policy of selling lids at less than the total cost of producing them, knowing such policy would make it difficult for Amhil to stay in the lid business, and might indeed force Amhil from the market. But... Portion did not cut prices so as to drive Amhil from the market. It cut prices to retain as much of the market as it could so as to minimize the losses it realized it was going to suffer because of the entry of a competitor into the market. The prices were cut to permit Portion to stay in the lid business until lids could be replaced by more profitable products. If Portion wished to drive Amhil from the lid market it was capable of doing so. Lids in 1975 represented only 12%, and in 1976, 5.8% of Portion's business. Backed by Consumers, Portion could have dropped prices so low as to force Amhil out of the market. It chose instead to cut prices in such a way as to likely ensure it would retain a substantial share of that market, so as to minimize its losses in losing the balance of it.
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> "There is no evidence that Portion sacrificed profit or a larger contribution to fixed overhead in an effort to drive Amhil from the market."

Speaking more generally, O'Leary, J. stated:

> "...where there is no evidence that the accused was not profit maximizing or loss minimizing, and where chronic excess capacity exists, an accused cannot be said to have sold at unreasonably low prices, regardless of its intent, if at all times it sold at prices above its average variable cost, there being no suggestion that such price was not also above its average marginal cost..."

He also stated:

> "In my view, section 34(1)(c) was not intended to prevent a manufacturer from selling at whatever price would bring it the largest profit or the smallest loss. A company selling at a price that gives it the best return is certianly not sacrificing present earnings with the hope of making up lost earnings later. Pricing so as to maximize profits or minimize losses in the short run is the very essence of competition, and is the kind of pricing that normal, healthy competition will foster in the fight for survival. It is the kind of pricing likely to occur if demand falls off because of a depressed market. When two competitors exist each more than capable of supplying the entire market, and the market is inelastic, short of collusion between them, sooner or later one of them is going to have to leave the marketplace. It follows that any cutting of price by either to retain or gain a portion of that market has the tendency to drive the other out of the market. In my view, section 34(1)(c) was not intended to make such cutting of price an offence so long as the cutting of price was loss minimizing."

With regard to the first of the two statements of Mr. Justice O'Leary quoted above, the judgment of Linden, J. in R. v. Hoffman-LaRoche Limited, (1980) 53 C.C.C. (2d) 1, provides an interesting comparison. In that case, which brought a conviction, Hoffman had given a drug away for an extended period of time with the design of eliminating competitors and substantially lessening competition. Linden, J. was concerned about whether prices were above or below full cost but did not ascribe any particlar significance to whether they were above or below variable cost. In his view, any price below full cost may or may not be held to be unreasonably low depending upon all the circumstances including the extent to which it is below cost, the period of time involved, whether the price cutting is offensive or defensive, and the long term benefits that will accrue to the seller. In addition, of course, he emphasized the requirement for proof that the unreasonably low price had the effect or tendency of substantially lessening competition or eliminating a competitor or that it was designed to have such an effect.