

Keys To Estimating Damages In Deceptive Pricing Cases

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By **Stephen Hamilton and Dan Werner** September 22, 2017, 11:41 AM EDT

There has been a recent rise in deceptive pricing claims against major retailers, with allegations that retailers have engaged in fictitious pricing, false advertising and phantom markdowns. Consumers in these cases typically contend that they were deceived by a retailer's reference to a "regular" or "full" price.

For example, a retailer might sell a product at \$9.99 while simultaneously presenting an allegedly inflated "compare at" price of \$14.99, even though an equivalent product never sold at this price, or the products being compared are not the same.

Retailers are also sometimes accused of engaging in "perpetual sales," which involves generating a deceptive price comparison because the products are always sold at "30% off" without ever being sold at full price. Deceptive pricing claims are particularly common against outlet-style retailers, which often sell discounted products made specifically for the outlet without being sold in their regular stores.

The liability fundamentals of deceptive pricing cases are easy to understand: To the extent that consumers are influenced by the perception of a bargain, a false or misleading reference price can result in higher prices and greater sales. However, providing defensible estimates of classwide damages has remained a significant stumbling block.

Recent Damage Methodologies

Recent deceptive pricing litigation has targeted well-known retailers, including [Best Buy Co.](#), [Amazon.com Inc.](#), [Overstock.com Inc.](#), [J.C. Penney Company Inc.](#), [Kohl's Department Stores](#), [Columbia Sportswear Company](#) and [Nordstrom Inc.](#)[1] In these cases, the plaintiffs generally claimed they would not have purchased the product (or would have purchased the product at a lower price) if not for the defendants' allegedly deceptive pricing.

Arguments in recent cases have largely focused on four approaches to damages: (1) a "full refund" approach, equal to the purchase price paid, (2) a "profit disgorgement" approach, which returns to plaintiffs the profit defendants made on the deceptively labeled products, (3) an "actual discount" approach, which applies the purported discount to a corrected reference price and compares that value to the actual prices paid,[2] and (4) a "price-value differential" approach, which calculates the value of the item purchased and compares that value to the actual price paid.

These four approaches have had varying levels of success,[3] underscoring the importance of a well-developed, factually-supported damage methodology that is appropriately tied to economic theory.



Stephen Hamilton



Dan Werner

We describe these approaches below, including how the fourth approach can be improved using hedonic regression analysis to isolate more precisely how much the deception causes the price to exceed the true retail value. We also suggest a fifth approach, which applies standard economic theory to directly estimate the artificially “induced demand” from deceptive pricing and, again, the price premium that this causes consumers to suffer.

Economic Theory Underlying the Calculation of Overcharge Damages

The economic theory behind deceptive pricing allegations is based on the concept that consumers gain information from prices. Economists typically classify the information content of goods in three ways: (1) “search goods,” whose features and quality are easily ascertained before purchase, (2) “experience goods,” whose features and quality are uncertain at the time of purchase but can be ascertained upon consumption (e.g., a restaurant meal), and (3) “credence goods,” whose features and quality cannot be ascertained even after consumption (e.g., whether a product actually contains a vitamin supplement).[4]

However, even products initially resembling search goods, such as a winter jacket, may contain characteristics of an experience good (e.g., longevity) or of a credence good (e.g., organic cotton). As a result, consumers regularly rely on characteristics such as brand and price to infer relevant information about a product (e.g., quality).

The economic foundation for damages in deceptive pricing claims is that retailers can exaggerate product quality by equating it to a recognized, high-quality brand or by comparing their price to a higher “regular” price. Academic research has long concluded that consumers derive pleasure from a perceived bargain, a concept known as “transactional utility.”[5]

Consistent with this theory, empirical research has demonstrated that elasticities of demand are larger during promotions than during ordinary price changes. In other words, demand is higher if consumers perceive a bargain, rather than just a regular price adjustment.

Thus, retailers have an economic incentive to exaggerate quality and create the perception of a bargain through a larger “compare at” price, or even through a “perpetual sale.” This practice artificially increases consumer demand, thereby allowing retailers to charge higher prices, while preserving or increasing their volume of sales. The challenge for plaintiffs is to recover the extent to which the price paid is higher than it would have been for the same item absent the misleading tactics.

Calculating Damages Resulting From Deceptive Pricing

Damages under the full refund and profit disgorgement methodologies are relatively straightforward to compute if sufficient sales and accounting data is produced. Some courts have accepted both approaches as proper measures of damages under the theory that every dollar spent (or earned) was a result of the deceptive pricing.[6] Other courts have rejected the same two methods, concluding that they fail to account for the fact that consumers received some value from purchasing the product.[7]

Each of the remaining three approaches seeks to estimate the amount by which the price paid by plaintiffs was higher than the price they would have paid but for the misleading conduct. The “but-for” price could be a reflection of the consumer’s expected bargain (as in the actual discount

approach) or of the product's true retail value (as in the price-value differential and induced demand approaches). The appropriateness of each approach will depend on the facts of the case and the available data.

Actual discount approach

Consider a case where consumers purchased a product offered on sale for \$15 with a "compare at" price of \$20, even though an equivalent product was never sold at \$20. The implied percentage discount is 25 percent. The "actual discount approach" seeks to estimate an accurate compare at price and then, using that price, determine what amount consumers would have paid had the defendant reduced it by 25 percent.

For example, if an economist estimates the appropriate compare at price is \$18, then a 25 percent discount means consumers would have paid \$13.50. Damages under this approach are defined as the difference between what consumers actually paid (\$15) and what they would have paid if the purported 25 percent discount was received: thus, damages equal \$1.50 per purchase (\$15 less \$13.50).

The idea behind this approach is that consumers are damaged by the difference between what they actually paid and what they would have paid, had they truly received the percentage discount they thought they were receiving. Plaintiffs' application of this method was deemed sufficient for class certification in the J.C. Penney case.

However, it was rejected by the court in the Kohl's case, where the court concluded that "the focus should be on what Plaintiff actually received given the price she paid, not on the bargain Plaintiff thought she was receiving."^[8] Under a similar rationale, this approach was also rejected in a case against Columbia Sportswear more recently.^[9]

Price-value differential approach

The price-value differential approach calculates damages equal to the difference between the price paid by consumers and the true retail value of the product. The challenge is how to reliably estimate this true retail value.

In the Kohl's case, the plaintiffs' expert proposed using the average or the mode (i.e., most common) price, and offered to calculate these using two different periods: 90 days preceding purchase and the full life span of the product. The expert preferred the longer look back period, but the court found the 90-day period more in keeping with the law.^[10]

The expert also offered the mode price as a better indicator of the true retail value than the average price, but the court rejected this position as speculative.^[11] As it turned out, for each product at issue in this case, both the average and the mode price over the prior 90 days were higher than the prices actually paid. Thus, under this approach, the "Plaintiff still received an item with a value higher than the price she paid."^[12] The court concluded that the plaintiff had failed to submit a viable measure of the price premium attributable to the false representation.^[13]

However, the difficulty faced by the plaintiffs' expert in Kohl's may not have been with the principle behind the approach, but rather with its implementation. There are at least two potential pitfalls to using the sales price in an earlier time period as an indication of a product's true retail value.

First, the prior period may also be contaminated by deceptive pricing behavior by the defendant, which would make the estimate of retail value too high and may erroneously imply no damages. Second, market conditions and, thus, the retail value of products can change between one period and the next, and this may need to be accounted for.

These pitfalls can be overcome using rigorous hedonic regression analysis that has been accepted by the courts in some product labeling cases to isolate the price premium attributable to the mislabeled product attribute (e.g., "organic").[14]

The hedonic regression approach recognizes that some products are a collection of attributes, and provides a method of estimating the "price" (or value) of each attribute, while controlling for the effect of changing market conditions (e.g., recessions) on prices. This approach can be used to estimate the true retail value (i.e., the "but-for" price), using either a prior period or a comparable product as a benchmark, while controlling for other differences across time or products.[15]

Hedonic regression analysis can also be applied to cases involving outlet-style retailers. Consider a product that is made specifically to be sold in an outlet-style store. If the outlet-style retailer deceptively equates this product to a higher quality branded product sold at premium stores, the price premium from the deceptive comparison may be related to that "brand premium." The hedonic regression approach can measure the "brand premium," or the true retail value of the product attributes, using actual retail sales data while controlling for a variety of other product differences.

Induced demand approach

The induced demand approach seeks to estimate the price premium generated by the defendants' deceptive pricing through directly investigating consumers' demand response to promotional discounts. The induced demand approach is especially helpful in cases where it is difficult to find a benchmark period when the product at issue was not deceptively priced, and difficult to find data on a sufficiently similar product that can be used to provide an estimate of the subject product's true retail value.

For instance, in a perpetual sale case, the subject product always remains on "sale," so there is no prior period of ordinary pricing to investigate. Moreover, in some cases there may be no closely comparable product sold elsewhere, making it difficult to estimate the true retail value of the product at issue. The induced demand approach can solve this problem and could be implemented as follows.

First, an economist estimates a model of supply and demand for the product at issue, which requires detailed pricing and sales data for that product. Among other things, this model informs the economist regarding the extent to which prices can be increased when there is a demand surge (whether artificially created or otherwise).

Second, the economist estimates the extent to which a sales promotion causes demand to surge when consumers see that a product appears to be sold at a bargain relative to the regular price. This estimation approach can be performed using retail data on the subject product (if the

deceptive price discount varies over time) or using other products which are comparable to the product at issue (because consumers' love of a bargain may be similar across different retail products).

This estimate is then plugged into the model from the first step, after making suitable adjustments for the exact nature of the defendants' allegedly deceptive discounting (e.g., the magnitude of the discount). The result is an estimate of the price premium that defendant can charge through the alleged deceptive pricing.

Stephen F. Hamilton, Ph.D., is a professor and the chair of the economics department at California Polytechnic State University, San Luis Obispo, as well as a testifying expert witness and senior consultant with OnPoint Analytics, an economic, financial and statistical consulting firm specializing in expert testimony in litigation. Dan Werner, Ph.D., CPA, is an economist at OnPoint Analytics. The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Nunez v. Best Buy Co. Inc., No. 0:15-cv-03965 (U.S. District Court: Minnesota). Branca v. Nordstrom Inc., No. 3:14-cv-02062 (US District Court: California Southern). Harris v. Amazon.com Inc., No. BC606984 (CA Superior Court: Los Angeles County). People of State of California v. Overstock.com Inc., No. RG10-546833 (CA Superior Court: Alameda County). Cynthia E Spann v. J.C. Penney Corporation Inc. et al, No. 8:12-cv-00215 (U.S. District Court: California Central). Wendy Chowning et al v. Kohl's Department Stores Inc. et al, No. 2:15-cv-08673 (US District Court: California Central). Jeanne Stathakos et al v. Columbia Sportswear Company et al., No. 15-cv-04543-YGR (U.S. District Court: California Northern).

[2] The actual discount approach is sometimes referred to as the "promised discount," "false discount," "transaction value" or "false transaction value" approach, for instance in the cases against J.C. Penney and Columbia Sportswear.

[3] For example, class certification was granted against J.C. Penney (and the case subsequently settled for \$50 million) after the plaintiffs' expert offered an application of the full refund, profit disgorgement, and actual discount approaches, while the court ruled against the plaintiffs' application of these same approaches, as well as the price-value differential approach, in the case against Kohl's (Cynthia E Spann v. J.C. Penney Corporation Inc. et al., No. 8:12-cv-00215, Order Re: Motion for Class Certification, at p. 31-34 (U.S. District Court: California Central, May 18, 2015); Wendy Chowning et al v. Kohl's Department Stores Inc. et al, No. 2:15-cv-08673, Order re: Defendant's Motion for Summary Judgment, at p. 5-13 (U.S. District Court: California Central, March 15, 2016)).

[4] Nelson, Phillip. "Information and consumer behavior." *Journal of Political Economy* 78, no. 2 (1970): 311-329. Darby, Michael R., and Edi Karni. "Free competition and the optimal amount of fraud." *The Journal of Law and Economics* 16 no. 1 (1973): 67-88.

[5] Thaler, Richard. "Mental accounting and consumer choice." *Marketing science* 4, no. 3 (1985): 199-214. Blattberg, Robert C., and Scott A. Neslin. "Sales promotion: The long and the short of it." *Marketing letters* 1, no. 1 (1989): 81-97.

[6] *Cynthia E Spann v. J.C. Penney Corporation Inc et al*, No. 8:12-cv-00215, Order Re: Motion for Class Certification, at p. 32 (US District Court: California Central, May 18, 2015).

[7] *Wendy Chowning et al v. Kohl's Department Stores Inc. et al.*, No. 2:15-cv-08673, Order re: Defendant's Motion for Summary Judgment, at pp. 7-10 (U.S. District Court: California Central, March 15, 2016).

[8] *Id.*, at p. 11.

[9] *Jeanne Stathakos et al. v. Columbia Sportswear Company et al.*, No. 15-cv-04543-YGR, Order Granting In Part Motions To Strike Experts; Granting In Part Defendants' Motion For Summary Judgment; Granting In Part Plaintiffs' Motion For Class Certification, at pp. 19-20 (US District Court: California Northern, May 11, 2017).

[10] The court noted that the False Advertising Law states that: "No price shall be advertised as a former price of any advertised thing, unless the alleged former price was the prevailing market price as above defined within three months next immediately preceding the publication of the advertisement. ..." *Id.*, at p. 12.

[11] *Id.*, at p. 13.

[12] *Ibid.*

[13] *Ibid.*

[14] Such regression techniques are routinely used in antitrust cases to make benchmark prices in competitive time periods, products or geographies, comparable to prices subject to alleged anticompetitive behavior.

[15] These techniques could also be applied to the estimation of the correct "compare at" price required for the application of the actual discount approach, if an expert wished to pursue that method.