Chapter 490: Spreading the Word on “Loss Leaders”

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Code Sections Affected

Government Code § 14837 (amended); Military and Veterans Code § 999 (amended); Public Contract Code §§ 10111, 10302, 10344, 12104.5 (amended).

AB 926 (Ruskin); 2009 STAT. Ch. 490.

I. INTRODUCTION

In the summer of 2008, California awarded a major state paper contract, which would involve printing the ballot statements for the upcoming general election.\(^1\) When the State made its first order for the ballot,\(^2\) the company filed a price change, which raised the actual price above offers from losing bidders.\(^3\) The State cancelled the contract.\(^4\) However, the State had to rush the order to a different contractor, which meant that an extra $800,000 of taxpayers’ money was spent.\(^5\)

Later that year, an investigation into the State’s office supply contract (for items such as staplers and sticky-notes) with Office Depot revealed several major inconsistencies.\(^6\) The investigation concluded that Office Depot had offered products at below cost prices; however, when state buyers went to purchase those products, the products were discontinued or sold out.\(^7\)

These marketing strategies—employing a “bait and switch” by first submitting “low ball bids” below cost and later charging higher prices for the same or different items—are known as “loss leaders.”\(^8\) The dictionary definition

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1. See SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009) (discussing the contract).
2. Id.
3. Id. at 2.
4. Id. at 3.
5. See id. (stating that, because the newsprint was to be used for an election, it had to be ready in time to meet the constitutional requirements for mailing ballots).
6. Id.
7. SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009).
of a “loss leader” is “an article sold at a loss in order to draw customers.” \(^9\) California law prohibits the practice of using a loss leader. \(^10\) The purpose of this law is to protect small businesses from going out of business by preventing larger businesses from selling products at prices that undercut the market. \(^11\)

While the law against loss leaders has been in place since the 1950s, there is one significant problem affecting its enforcement: the prohibition of loss leaders is not widely known. \(^12\) For example, during the investigation of the Office Depot contract, the auditors were asked whether they had checked to see if Office Depot was illegally using loss leaders. \(^13\) Although “the law was passed in the 1950s and updated during the 1960s,” the auditors responded that they were unaware of the law and asked if it was new. \(^14\)

The goal of Chapter 490 is to curtail this practice by making it clear to bidders on state contracts that the use of loss leaders is illegal in California. \(^15\) By requiring a clause in the bids discussing the illegality of the use of loss leaders, Chapter 490 may prevent future bidders from claiming that they were not aware of the law. \(^16\)

II. BACKGROUND

California’s longstanding history with laws against the use of loss leaders began in 1933, when California became “the first state to enact a specific and comprehensive below cost statute.” \(^17\) In 1941, California passed the California Unfair Practices Act, \(^18\) which specifically prohibited the use of loss leaders in

so the corporate store is losing $2 for every hammer they sell. The corporate store is willing to take the loss in order to bring in customers who may choose to buy other items which are priced above cost.

In the most extreme situation, the corporate store could choose to sell everything in the store at a loss. The corporation could take profits from other stores around the country to set-off the losses at this store and keep it operating. Meanwhile, the local store cannot lower its prices to the corporate store’s level and still be able to pay the rent.

Eventually, the local store loses customers due to the lower prices and eventually goes out of business. Now the corporation can raise its prices back above cost and has successfully taken over the entire market for hardware in the town and driven the local store out of business.

10. Cal. Bus. & Prof. Code § 17044 (West 2008); see also Senate Committee on Governmental Organization, Committee Analysis of AB 926, at 2 (June 23, 2009) (discussing the prohibition against loss leaders).
11. Senate Committee on Governmental Organization, Committee Analysis of AB 926, at 2 (June 23, 2009).
12. Id. at 3.
13. Id.
14. Id.
15. Id.
16. Id.
17. McCarthy, supra note 8, at 169.
California. In 1953, the Act was significantly amended, resulting in the current version, which specifies that “[i]t is unlawful for any person engaged in business within this State to sell or use any article or product as a ‘loss leader’ as defined in Section 17030 of this chapter.”

Section 17030 of the Business and Professions Code uses the traditional dictionary definition of a loss leader: “any article or product sold at less than cost.” However, the statute narrows the definition by providing that the product must be sold at less than cost: “(a) [w]here the purpose is to induce, promote or encourage the purchase of other merchandise; or (b) [w]here the effect is a tendency or capacity to mislead or deceive purchasers or prospective purchasers; or (c) [w]here the effect is to divert trade from or otherwise injure competitors.”

The courts have interpreted this definition even more narrowly than the words of the statute indicate. In Western Union Financial Services, Inc. v. First Data Corp., Western Union sued First Data for a violation of the Unfair Practices Act, alleging that First Data sold its services below cost to divert customers from Western Union. First Data specifically mentioned Western Union in its advertisements and any increase in customers to First Data necessarily came at the expense of customers to Western Union because these two companies were the only ones in the market. Although this practice would seem to clearly fit within the definition of a prohibited loss leader as it has the effect of “divert[ing] trade from or otherwise injur[ing] [a] competitor[,]” the court held that First Data did not have an “injurious intent” and did not violate the Act. While section 17030 makes no mention of an intent requirement, the court read the statute “to require an injurious intent (a specific intent to injure or destroy) and not just an intent to divert customers from a competitor.”

Under the Act, a showing that a product is being sold at a loss and that it has an injurious effect upon a competitor creates a presumption that firm has an injurious intent. In Western Union, the court found that the presumption had been raised, but First Data successfully rebutted this presumption “when it presented evidence of its good faith intent to use this promotion to increase and maintain its customer base.”

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19. The 1941 Act provided that “[t]he practice of using any article or product as a ‘loss leader’ is included among the prohibitions of this chapter.” 1941 Cal. Stat. ch. 526, § 1.
22. Id. § 17030.
23. Id.
25. Id. at 1532, 25 Cal. Rptr. 2d at 341.
26. Id. at 1541, 25 Cal. Rptr. 2d at 347.
27. CAL. BUS. & PROF. CODE § 17030(c) (West 2008).
29. Id. at 1540 n.10, 25 Cal. Rptr. 2d at 346 n.10.
30. CAL. BUS. & PROF. CODE § 17071 (West 2008).
This result is consistent with the Legislature’s intent “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.” If the Act was used by large companies, such as Western Union, to stifle competition from smaller and new competitors, such as First Data, the Act would be used to subvert its own goals.

III. CHAPTER 490

Chapter 490 requires a state entity to include a statement about the prohibition of the use of loss leaders when it announces that it is seeking bids for a contract. Specifically, Chapter 490 requires that “a solicitation for a state contract for goods,” a request for proposal for a contract for services that involves the furnishing of equipment, materials, or supplies and a request for proposal for a state contract for the acquisition of information technology goods and services** include a statement that “[i]t is unlawful for any person engaged in business within this state to sell or use any article or product as a ‘loss leader’ as defined in Section 17030 of the Business and Professions Code.” In addition to this new requirement, Chapter 490 makes several non-substantive changes to current law.

IV. ANALYSIS

Chapter 490 requires that when the State of California seeks bids from contractors, those contractors must be warned that use of a loss leader is illegal under California law. Chapter 490 is a response to an investigation of state contracts determining that even the state auditors were not aware of California’s law against the use of loss leaders. While the prohibition against loss leaders is

32. CAL. BUS. & PROF. CODE § 17001 (West 2008).
33. See id. (discussing the purpose of the Unfair Practices Act).
34. SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 1 (June 23, 2009).
35. See CAL. PUB. CONT. CODE § 10302 (amended by Chapter 490).
36. See id. § 10344 (amended by Chapter 490).
37. Id. § 12104.5 (amended by Chapter 490); see also SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 1 (June 23, 2009) (citations added); CAL. PUB. CONT. CODE § 12104 (West 2008).
38. CAL. PUB. CONT. CODE §§ 10302(b), 10344(c)(1), 12104.5(b)(1) (amended by Chapter 490).
39. See, e.g., CAL. GOV’T CODE § 14837 (amended by Chapter 490) (changing two instances of the word “that” to “which”); CAL. MIL. & VET. CODE § 999 (amended by Chapter 490) (changing five instances of the words “State of California” to “state”).
40. SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009).
41. Id.
subject to judicial interpretation, it is possible that the recent actions by companies attempting to win bids for state contracts violated the law. When these companies offered items at below cost, they attempted to “mislead or deceive purchasers or prospective purchasers.” Chapter 490 seeks to address these issues and avoid these practices “by informing everyone of the loss leader law.”

In recent years, there have been several legislative attempts to change California law to increase the involvement of small businesses in state contracts. These included attempts to increase from five to ten percent the preference for small and micro businesses when awarding state contracts and attempts to increase penalties for misrepresenting the involvement of small businesses in state contracts. Rather than attempting to create a new scheme to increase the participation of small businesses in state contracts, Chapter 490 is a reminder that the current law already has protections for small businesses against their larger competitors.

Implementing Chapter 490 has a minor fiscal impact. The California Department of General Services estimates that it will cost approximately $70,000 in one-time costs to implement Chapter 490. This figure includes $30,000 to insert the new language into the general terms and conditions for the specified contracts and $40,000 “to develop support policies in the State Administrative Manual.” Despite these costs, no opposition is registered against Chapter 490. Chapter 490 has received support from the California Black Chamber of Commerce and the California Small Business Association.

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43. CAL. BUS. & PROF. CODE § 17030(b) (West 2008).
44. SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009).
45. See, e.g., AB 2773, 2008 Leg., 2007-08 Leg. Sess. (Cal. 2008) (as introduced on Feb. 20, 2008, but not enacted) (proposing substantive changes to existing law relating to procurement procedures to increase the participation of small businesses).
48. The stated goal of Chapter 490 is to inform all parties about the loss leader prohibition that is already part of California law. See SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009).
49. SENATE COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF AB 926, at 1 (July 13, 2009).
50. Id.
51. SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 5 (June 23, 2009).
52. Id. at 4-5.
V. CONCLUSION

While using loss leaders is illegal in California,\(^{53}\) their use is especially egregious when companies use them to procure state contracts that waste taxpayer money.\(^{54}\) Chapter 490 will make contractors aware of the already-existing prohibition of loss leaders by requiring state solicitations for contracts and requests for proposals to include a statement reminding the contractors that the use of a loss leader is illegal under California law.\(^{55}\)

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53. CAL. BUS. & PROF. CODE § 17044 (West 2008).

54. See SENATE COMMITTEE ON GOVERNMENTAL ORGANIZATION, COMMITTEE ANALYSIS OF AB 926, at 3 (June 23, 2009) (discussing how several instances of contractors’ use of loss leaders have negatively affected the price of state contracts).

55. Id. at 1.