ECONOMICS COMMITTEE NEWSLETTER

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Deceptive Marketing Practices: How Some Consumers Benefit When Others are Deceived

Sean Durkin[1]

Many recent cases include allegations that false advertising, disparagement, or other deceptive practices constitute anticompetitive conduct. These allegations are often part of claims that a defendant has engaged in a broader set of anticompetitive conduct. For example, the DOJ's complaint against Intel alleged that Intel manipulated CPU performance benchmarks and deceived customers as one of several forms of conduct that allegedly strengthened and maintained its monopoly.[2] Recently, however, a Texas jury found Becton-Dickinson guilty of attempted monopolization based solely on its allegedly false advertising, even though the plaintiff also alleged that Becton-Dickinson engaged in anticompetitive contracting practices.[3]

Courts have generally adopted the consensus view of legal scholars that the presumption should be that false advertising and other deceptive promotional practices have a *de minimis* effect on competition. According to this consensus view, deception is unlikely to have a large effect on relative demand for rivals' products, in part at least, because few consumers are likely to be deceived. Consumers have many sources of information other than a company's claims about its own or its rivals' products, and rivals can counter the effects of deception by engaging in their own promotional activities. Thus, even if deception harms competitors, that harm will, except in rare cases, be insufficient to harm competition, so allegations of deceptive practices should be restricted to tort claims.

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[2] *See*, http://www.ftc.gov/sites/default/files/documents/cases/091216intelcmpt.pdf.

[3] *See*, Retractable Technologies, Inc. and Thomas J. Shaw v. Becton Dickinson & Company, No. 2:08-cv-16 (M.D., Sept. 19, 2013).

In many of the recent cases, however, plaintiffs and their experts have argued that deceptive practices have contributed to monopoly acquisition or maintenance without any allegation that a large share of buyers were deceived. For example, as part of their antitrust claims against Keurig Green Mountain, plaintiffs claimed that Keurig made false and disparaging statements about its competitors' portion packs.[4] Similarly, as part of their claims against News America Marketing, plaintiffs claimed that News America deceived their customers by disparaging their rivals' compliance rates.[5] Microsoft is still being sued for creating fear, uncertainty, and doubt about its rivals products during the 1990s.[6] The implicit, and sometimes explicit, claim by plaintiffs in these cases is that deception should be considered anticompetitive conduct, even if few buyers are actually deceived, because deception raises rivals' costs and has no procompetitive justification.

This article discusses why deceptive promotional practices may not harm competition even if it cannot be countered by rivals and a large share of buyers is deceived. By deceptive promotional practices, I mean practices that impact the willingness to pay for a company's product relative to its rivals' products. Thus, deceptive promotional practices could be a company making false statements about the quality of its own products and/or the quality of its rivals' products. For example, the FTC alleged that Intel manipulated the performance benchmarks which deceived consumers and gave an incorrect impression of the performance of Intel processors relative to AMD processors.

This article shows that promotion of a seller's product, whether deceptive or truthful, can increase competition between sellers by inducing them to more aggressively compete for buyers who would otherwise view the

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[4] *See e.g.*, In Re: Keurig Green Mountain Single Serve Coffee Antitrust Litigation, JBR, Inc. v. Keurig Green Mountain, Inc., No 1:15-cv-04242-VSB-HBP (First Amended and Supplemental Complaint, November 25, 2014).

[5] *See*, The Dial Corporation, et. al. v. News America Marketing, LLC, No. 2:12-cv-15613-AJT-MKM (Second Amended Complaint, March 26, 2013).

[6] *See*, Go Computer, Inc., v. Microsoft Corporation, No. CGC-05-442684 (Fifth Amended Complaint, June 29, 2005.)

two products as close substitutes. While deception reduces the sales of the deceiving firm's rivals and harms buyers who are deceived, buyers who are not deceived can be better off because deception leads to lower prices for them.

The basic intuition is that, when sellers cannot price discriminate, they may not compete aggressively for buyers who view their products as close substitutes for their rivals' product because it would require them to lower prices to loyal buyers with more inelastic demand. Advertising and promotion is often targeted at buyers who view rivals' products as close substitutes. When promotion raises the willingness-to-pay for a seller's products, it can induce sellers to compete more aggressively for those buyers.

This implies that the assertion that deceptive practices have no procompetitive justification is incorrect. Buyers that are not affected by the promotion benefit because it increases competition for those affected by the promotion. When the promotion is deceptive, deceived buyers are harmed because they are deceived and not due to any harm to competition caused by the deception.

In addition, this article sheds light on claims often made by classes of plaintiffs under state consumer protection statutes that deceptive practices lead to higher prices for all consumers. The economic logic behind these claims is that deception, even of a limited number of consumers, artificially raises the demand for the defendant's product, causing all consumers to pay higher prices. The analysis in this paper shows that artificially raising the demand for some buyers need not lead to higher prices for all consumers. In fact, deceiving some customers can cause prices to be lower for consumers who were not deceived. This has implications for both class certification and damages issues in these cases.

A. Background

For some time, legal scholars have debated whether deceptive promotional practices should be considered antitrust violations. There is a general consensus that while the deceptive promotional activity harms competitors it is unlikely, except in rare circumstances, to harm competition.

Deception is unlikely to harm competition because a large share of consumers is unlikely to be deceived, in part at least, because rivals can counter with their own promotion.[7]

Areeda and Hovenkamp argue that there should be a presumption that deception has a *de minimis* effect on competition unless the plaintiff can show that the promotional activities were: (1) clearly false, (2) clearly material, (3) clearly likely to induce reasonable reliance, (4) made to buyers without knowledge of the subject matter, (5) continued for prolonged periods, and (6) not readily susceptible to neutralization, or other offset, by rivals.[8] If plaintiffs are unable to meet this burden, they argue that deceptive promotional practices should be limited to tort statues such as the Lanham Act. Courts have generally adopted this consensus view in cases alleging anticompetitive deceptive promotion.[9]

The alternative view often expressed by plaintiffs and their experts is that, because it has no procompetitive justification, deception should be considered an antitrust violation because it makes it harder for rivals to compete and raises their costs. This is consistent with the view, expressed by some, that there is little harm from treating tortious conduct as an antitrust violation because one need not be concerned about false positives if the conduct has no procompetitive justification.[10]

From a practical standpoint, there are at least two reasons why plaintiffs would prefer to have their claims evaluated under the Sherman Act

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[7] *See* Patricia Schultheiss and William E. Cohen, *Cheap Exclusion: Role and Limits*, at 4-5. http://www.ftc.gov/system/files/documents/public_events/section-2-sherman-act-hearings-single-firm-conduct-related-competition/section2cheapexclusion.pdf

[8] 3B PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶¶ 782a–b, at 321 (3d ed. 2008).

[9] *See* Patricia Schultheiss and William E. Cohen, *Cheap Exclusion: Role and Limits*, at 4-5. http://www.ftc.gov/system/files/documents/public_events/section-2-sherman-act-hearings-single-firm-conduct-related-competition/section2cheapexclusion.pdf.

[10] Susan A. Creighton, D. Bruce Hoffman, Thomas G. Krattenmaker & Ernest A. Nagata, *Cheap Exclusion*, 72 ANTITRUST L.J. 975, 989 (2005).

rather than tort statues. First, plaintiffs would be entitled to treble damages for violations of the Sherman Act. Second, a plaintiff with, for example, a weak case that a defendant's contracting practices are exclusionary may want to include a false advertising claim in the hope that a jury will believe that the deception is sufficiently objectionable that it finds the defendant in violation of the Sherman Act even if the contracting practices were not exclusionary.

Economics does not generate any unambiguous predictions about the effect of deceptive advertising on competition and consumers. There has been some economic analysis of the effectiveness of truthful advertising and promotion on competition.[11] Informative advertising has been shown to be able to increase competition and lead to lower prices because buyers that are better informed about prices or product characteristics have more elastic demand. Persuasive advertising, on the other hand, has been shown to potentially reduce competition and lead to higher prices because it allows sellers to better differentiate their products, making demand more inelastic. However, some have noted that when sellers cannot price discriminate, the ability of a seller to differentiate its products through persuasive advertising can increase competition by increasing the willingness-to-pay for marginal customers.[12]

There is, however, little to no economic analysis that examines the effect of deceptive promotion on competition. Below, I present a framework for assessing whether the type of deceptive promotion at issue in recent cases can harm competition and consumers by reducing competition.

B. Example

Suppose there are two sellers that sell one product and that both have a constant marginal cost of 5. Assume also that there are three types of buyers that purchase one unit of the product. Loyal buyers will only buy from

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[11] Anthony J. Dukes, *Advertising and Competition*, *Advertising and Competition*, *in* ISSUES IN COMPETITION LAW AND POLICY 515 (ABA Section of Antitrust Law 2008).

[12] *See*, Gary S. Becker and Kevin M. Murphy, *A Simple Theory of Advertising as a Good or Bad*, 108 Q. J OF ECON., (4), 955-56 (1993).

Seller 1 and are willing to pay 20 for Seller 1's product. Sophisticated buyers view the products from Seller 1 and 2 as substitutes and buy the cheapest product. In the absence of any promotion, naïve buyers are identical to sophisticated buyers, but promotion by Seller 1 can increase the naïve buyers' willingness-to-pay for its product. Assume naïve and sophisticated buyers are willing to pay 12 for either seller's products without any promotion. Assume also that each seller knows there are 40 loyal, 40 naïve, and 20 sophisticated buyers but that neither seller knows which customers are loyal, naïve, and sophisticated.

One can think about Sellers 1 and 2 hypothetically as Intel and AMD. There may be some loyal buyers that will only buy PCs with Intel processors. Sophisticated buyers may not care whether their PC has an AMD or Intel processor and will buy whichever PC is cheaper and cannot be influenced by Intel's promotional efforts. This may be because they rely on other sources of information rather than Intel's promotional activities. Intel's promotional efforts may, however, increase naïve buyers' willingness-to-pay for its product relative to the AMD product.

In this hypothetical example, the assumption that only Intel can promote its products means the promotional activities under consideration are those that cannot be countered by AMD. The assumption that sellers cannot distinguish between the different types of customers means they cannot price discriminate.

1. Outcomes with no promotion

Consider first what happens when Seller 1 does not promote its products. Seller 1 has loyal buyers over which it effectively has monopoly power, and it can charge them their willingness-to-pay. If it only sells to loyal buyers, Seller 1 charges a price of 20. With a marginal cost of 5, it earns a profit of 15 per unit for 40 units for a total profit of 600.

For Seller 1 to be willing to lower its price to compete for naïve and sophisticated customers, it would have to earn a profit of at least 600. Thus, Seller 1's minimum price is 11. At that price, it earns a profit of 6 per unit and sells a total of 100 units. Since Seller 2 has no loyal customers, its minimum

price equals its marginal cost of 5. If Seller 1 charges its minimum price Seller 2 can charge a price just below 11 and capture all the sales to naïve and sophisticated customers.

Therefore, without any promotion, Seller 1 charges a price of 20 and sells only to loyal customers, while Seller 2 charges a price just below 11 and sells to the naïve and sophisticated customers. Since the price paid by loyal customers equals their willingness-to-pay, their surplus equals zero. The surplus for the 60 naïve and sophisticated customers equals 1 per customer because they pay 11 and have a willingness-to-pay of 12. The average price for all customers without promotion is 14.6. (See Table 1 for all the relevant values.)

TABLE 1

	Seller 1	Seller 2
Marginal cost	5	5
Loyal buyers	40	0
Non-contested price	10	10
Willingness-to-pay of loyal buyers	20	
Willingness-to-pay of sophisticated buyers	12	12
Willingness-to-pay of naive buyers without promotion	12	12
Minimum price without promotion	11	5
Price without promotion	20	11
Sales without promotion	40	60
Profits without promotion	600	360
Customer surplus without promotion	0	60
Profits with loyalty discounts	200	100
Minimum price with promotion	11	5
Willingness-to-pay of naive buyers without promotion	18	12

	Seller 1	Seller 2
Price with promotion	13.5	11
Sales with promotion	80	20
Gross profits with promotion	680	120
Customer surplus with promotion	440	20
Customer surplus with promotion	200	20

2. Outcomes with promotion

By promoting its products, Seller 1 can raise naïve customers' valuation of its product relative to their valuation of Seller 2's product. If the increase in the willingness-to-pay for Seller 1's product is sufficiently large, then Seller 1 may be able to profitably compete for naïve customers.

To determine whether Seller 1 can profitably compete for naïve customers, we need to know Seller 1's minimum price to compete for naïve customers. Recall that it earns a profit of 600 if it only competes for loyal customers, so its minimum price gives it a profit of 600 if it sells to the 40 loyal customers and 40 naïve customers. Seller 1's minimum price is now 12.5 because if it charges 12.5 it earns a per unit profit of 7.5 per unit, so its total profit on 80 units is 600.

Seller 2's minimum price also changes when promotion is possible. Since Seller 1 would never price below 11, Seller 2 can price just below 11 and sell to sophisticated customers no matter how much Seller 1 promotes its products. If so, it earns a profit of 6 per unit on the 20 sophisticated customers for a total profit of 120. If Seller 1 promotes its products, then Seller 2 will lower its price below 11 to compete for naïve customers as long as the profits it earns from doing so are not less than 120. Seller 2's minimum price is 7.5 because it would earn 2.5 per unit on sales to 60 customers for a total profit of 120.

Given these minimum prices, the next question is whether Seller 1 can sufficiently raise the willingness-to-pay of naïve buyers so that they would prefer buying from Seller 1 if both sellers charge their minimum prices. Since

the difference between Seller 1's minimum price and Seller 2's minimum price is 5, Seller 1's promotion has to raise naïve buyers' willingness-to-pay by 5, from 12 to 17.

For example, suppose that Seller 1's promotion raises naïve buyers' valuation to 18. If so, Seller 2 would need to price below its minimum price to sell to naïve customers, so it will not find it profitable to compete for those customers. If naïve buyers have a willingness-to-pay of 18, Seller 1 can charge above its minimum price and sell to naïve buyers. If it charges just below 13.5, naïve buyers will prefer to buy from Seller 1. At a price of 13.5, Seller 1 will earn a profit of 8.5 per unit on sales to 80 customers for a total of 680 which exceeds the profits it earned without promotion. Thus, Seller 1 will find it profitable to promote its products if the promotional costs of increasing naïve buyers' willingness-to-pay by at least 6 are less than 80. If so, then Seller 1 will promote its products and compete for sales to naïve buyers.

3. Comparing outcomes with and without promotion

Suppose that the profit maximizing level of promotion for Seller 1 leads to an increase in naïve buyers' valuation of Seller 1's product to 18. How does that promotion affect buyers and sellers?

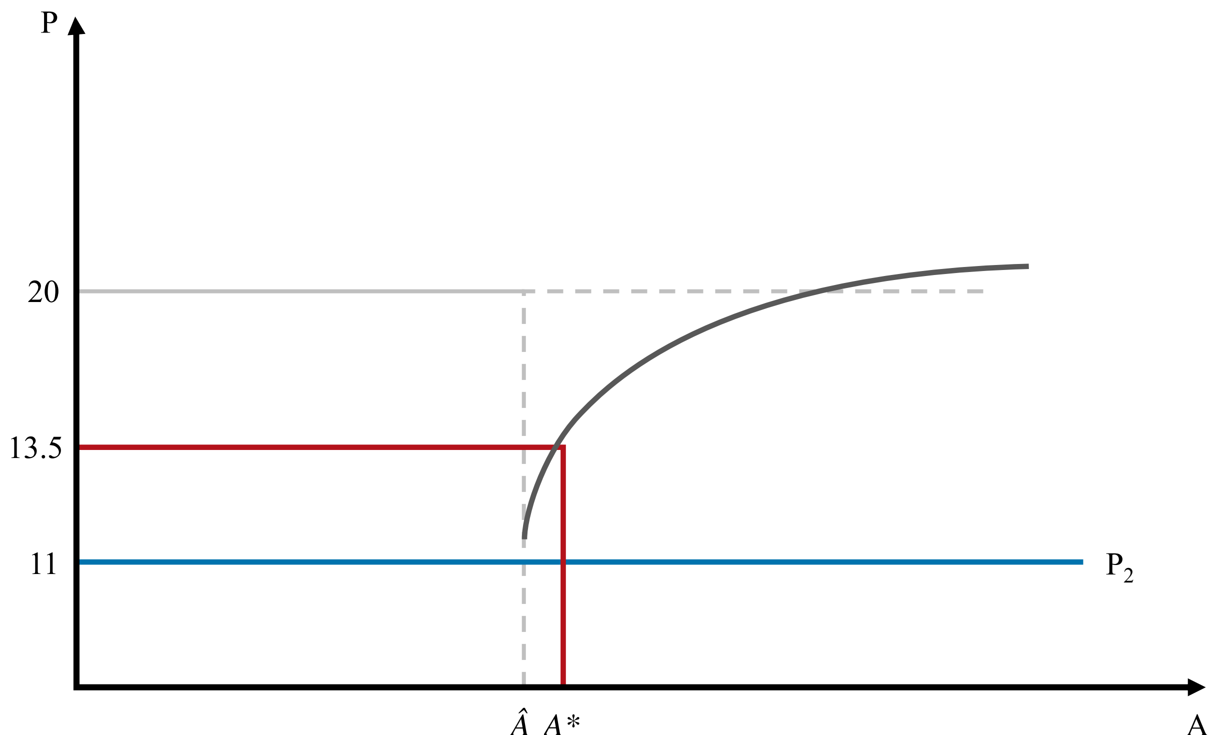
The increase in competition, due to the promotion, benefits both loyal and naïve buyers. Loyal buyers pay 13.5 rather than 20, so their surplus rises to 6.5 per customer. Naïve buyers also pay 13.5 which is higher than the 11 they pay without promotion, but their surplus rises to 4.5 per customer because their willingness-to-pay has risen to 18. Sophisticated buyers' surplus is unchanged because they still pay 11 and there is no change in their valuation of Seller 2's product. Total buyer surplus rises to 460 from 60 without promotion. Average prices fall from 14.6 without promotion to 13 with promotion.

The increase in competition harms Seller 2. Its profits are 350 without promotion and 120 with promotion. Because of the inability to price discriminate, Seller 2 had an advantage competing for naïve customers without promotion because it does not have any loyal customers. As a result,

it does not lose profits by reducing its price. By promoting its product, Seller 1 can offset Seller 2's advantage, so Seller 2 loses sales to naïve customers.

Figure 1 illustrates the effect of promotion on prices graphically by showing how the profit maximizing prices of the two sellers changes as the level of promotion by Seller 1 increases. The black line represents seller 1's price. For low levels of promotion below $\hat{A}$, Seller 2 can profitably price low enough to induce naïve buyers to buy its products even though they have a higher valuation of Seller 1's product. As a result, Seller 1 prices at 20, and Seller 2 prices at Seller 1's profit neutral price of 11. Seller 1 would never choose levels of promotion below $\hat{A}$ because it would be devoting resources to promotion even though it would not make sales to naïve buyers. Once the level of promotion reaches $\hat{A}$, then the difference in naïve buyers' valuation of Seller 1's product relative to Seller 2's product is sufficiently large that Seller 1 would reduce its price to 12.5 and compete for naïve buyers. It may be profit maximizing for Seller 1 to choose a level of promotion above $\hat{A}$, because the difference in naïve buyers' valuation rises as the level of promotion rises.

Figure 1



If A* represents the profit maximizing level promotion and naïve buyers' valuation of Seller 1's product is 18 at A*, then Seller 1 charges a price of 13.5.

4. Outcomes with deceptive promotion

Suppose now that Seller 1's promotion is deceptive in that it artificially raises naïve customers' willingness-to-pay. The fact that the promotion is deceptive has no effect on competition. Deception causes Seller 1 to reduce prices and compete for naïve customers in the same way that truthful advertising does, and loyal customers benefit. Prices are the same with truthful and deceptive promotion, so deceptive promotion causes average prices to fall relative to no promotion.

The only difference between deceptive and truthful advertising is its effect on the surplus of the naïve customers. Their surplus is negative 1.5 because they pay 13.5 but their true valuation is only 12. Total surplus across all buyers is 220 which is less than with truthful promotion, but still more than with no promotion. Thus, the negative effect of deception on the deceived buyers is less than the positive effect on buyers that are not deceived. Since deception has no effect on sophisticated customers, any harm is limited to the naïve customers. Moreover, that harm does not come about because of a reduction in competition because the deception has actually increased competition.

C. Implications

1. Implications for antitrust cases

The argument that there should be a presumption that deceptive promotion does not harm competition is based on the belief that deceptive practices are not likely to deceive a large share of buyers and, therefore, are unlikely to affect competitors sufficiently to harm competition, except in rare cases. The analysis above provides another reason why deception is unlikely to harm competition. Deception can increase competition even if a large share of buyers is deceived.

Proponents of treating deceptive promotion and other torts as antitrust violations have often claimed that the conduct has no procompetitive justification. As a result, allowing deception claims to be part of antitrust cases will not discourage any procompetitive conduct. This analysis shows that this argument is incorrect. First, deceptive promotion can increase competition and benefit buyers, so it does have procompetitive effects. Second, truthful promotion has an even greater beneficial effect on buyers, but companies may be cautious about engaging in truthful promotion if they run the risk that they will be subject to antitrust scrutiny over their advertising if there is any dispute about its accuracy. This is particularly important because, as discussed above, juries may be more willing to find a defendant guilty of anticompetitive conduct because they find deception objectionable.

This does not rule out the possibility that deception can harm competition. Deception reduces sales of the sellers that cannot counter their rivals' deceptive promotion. If a company cannot cover its fixed costs as a result of the reduction in sales, then the deception can harm competition. The same could be true if the reduction in sales raised a company's marginal costs. Even if this happens, however, these potentially adverse effects would have to be weighed against the fact that the deception has increased competition.

2. Implications for class action cases brought under consumer protection statutes

The above analysis also has implications for assessing consumer class action claims that they paid higher prices because of deceptive practices. For example, in addition to the FTC's allegations that Intel's alleged manipulation of CPU performance benchmarks harmed competition, Intel has been sued by classes of consumers under different state consumer protection statutes claiming that they paid higher prices because of the alleged deception.[13]

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[13] Janet Skold and David Dossantos v. Intel Corporation, Hewlett Packard Company, Superior Court of the State of California for the County of Santa Clara, Case No. 1-05-CV-039231.

Plaintiffs in class action cases involving deceptive promotion argue that it has a common impact on all buyers of a defendant's product because it artificially raises demand, leading to higher prices for all buyers. In other words, the common harm suffered by class members is because the deception of some buyers led to higher prices for all buyers.

The analysis above shows that the economic logic behind these claims is incorrect. First, even if deception artificially increases demand for a seller's product, it need not lead to higher average prices. Second, if deception leads to higher average prices, some buyers can pay lower prices because deception can increase competition. Thus, there is not necessarily a class wide common impact because buyers that are not deceived benefit from the deception. Thus, plaintiff classes cannot satisfy Rule 23 or equivalent state statutes simply by claiming that deception led to higher demand for some class members.

D. Conclusion

Evaluating the competitive effects of deceptive promotion through the economic framework described in this article has several important implications. First, when sellers' promotional efforts raise the willingness-to-pay of marginal buyers, it can increase competition and lead to lower prices on average. Second, the effect of promotion on competition is independent of whether the promotion is deceptive or truthful. Third, while buyers can be harmed by deceptive promotion, any harm that occurs is not necessarily because of a reduction in competition. Fourth, deceptive promotion can lead to higher prices for deceived buyers and lower prices for all other buyers, so there is not necessarily a common price impact of deceptive promotion on all buyers of a seller's product.