

BY JOSH CHETWYND

# Up against the Wal- Mart?

Small-town

pharmacists:

It's predatory

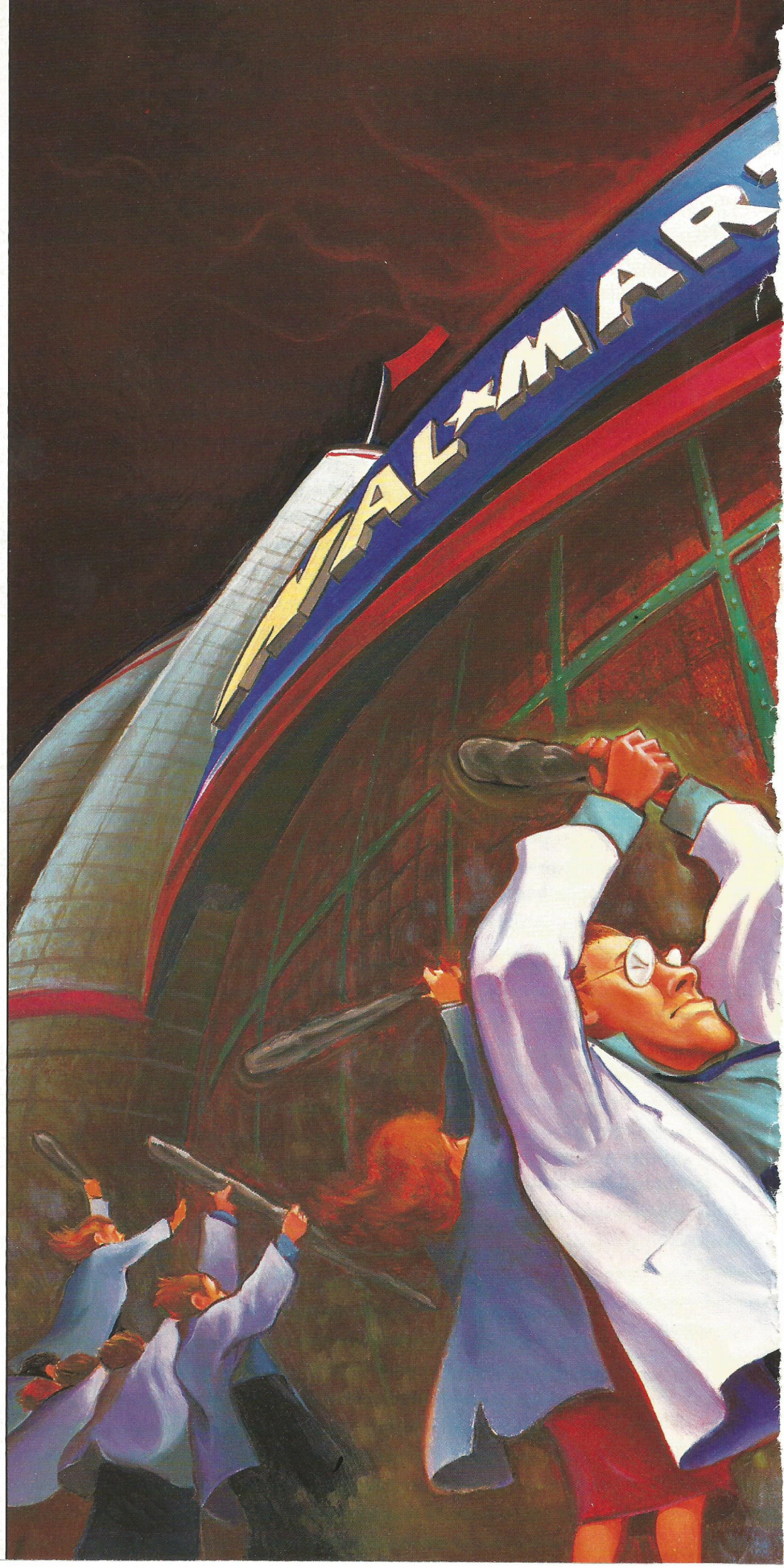
pricing;

The retail giant:

No, it's free trade

**D**avid versus Goliath — that is how small business owners from Colorado to Arkansas portray their battle with Wal-Mart. With nearly 2,000 stores and a net income of \$1.99 billion in 1993, the mega-retailer is bound to step on a few toes, but some businesses are alleging that in Wal-Mart's rise to be No. 1 it has broken the law.

Brad Walker



Hurling words like "predatory pricer" and "anti-competitive," mom and pop businesses, especially corner drugstores, claim they are going out of business because Wal-Mart illegally lowers prices below cost with the express purpose of putting competitors out of business.

These businesses contend that Wal-Mart will play by its own rules if it will help business. Matthew Adlong, who represented three

## Small businesses are turning to the courts for relief.

small pharmacists in a successful suit against Wal-Mart, says, "Wal-Mart acted as if the law didn't apply to them."

Wal-Mart, which has increased its net income every year since 1984, argues that it just wants the right to run its business as it chooses — and as efficiently as possible.

When contacted by *Business Law Today*, the company's general counsel, Robert Rhoads, would only say, "I expect oral arguments for the appeal in May and I believe we are going to be successful. I should have more to say then, but for now I don't make it a practice to talk about pending litigation."

In October, Rhoads told *The New York Times*, "We will always strive to be the low-cost leader wherever we are. Not to injure anyone, but because we have made a promise to our customers."

*Chetwynd, a student at Northwestern University in Evanston, Ill., wrote this article as an intern with Business Law Today.*

Wal-Mart also argues that the below-cost laws that small business owners base their complaints on are not constitutional.

"The commerce clause of the Constitution protects against interference of interstate trade and says that no states may enact laws that impede interstate commerce," says Charles Shipley, who served as outside counsel for Wal-Mart in an Oklahoma predatory pricing case. "What Wal-Mart sells comes some 90 percent from other states and these below-cost laws affect that commerce."

In the case Shipley handled, the Federal Trade Commission wrote an amicus brief supporting Wal-Mart's assertion that the Oklahoma below-cost statute actually led to less competition and was unconstitutional. The judge, however, found the below-cost law constitutional. Two other judges in different states have also upheld below-cost statutes in Wal-Mart cases.

In recent years, small businesses, like those in the Oklahoma case, are turning to the courts to contest the legality of Wal-Mart's business practices. While the corner drugstore owners have yet to connect with a crippling blow, courtroom results have begun to highlight some of Wal-Mart's practices:

- In October 1993, an Arkansas circuit court ordered Wal-Mart to pay three pharmacists in Conway, Ark., more than \$288,000 in damages. The judge ruled that Wal-Mart was selling key goods below cost with the purpose of pushing the pharmacists out of business.

- In March 1993, Wal-Mart settled with a Cortez, Colo., pharmacist after the below-cost statute the suit was based on was found constitutional. Wal-Mart asked that the terms of the settlement remain confidential, but the giant retailer did raise its prices.

- In 1988, Wal-Mart agreed to a settlement with a group of Hominy, Okla., pharmacists after Wal-Mart unsuccessfully questioned the constitutionality of the statute the case

was based on. Wal-Mart insisted that the terms of the settlement remain confidential, but was forced to increase prices.

- In August of 1994, another pharmacist in Pine Bluff, Ark., will go to court against Wal-Mart. Like others, this suit contends that Wal-Mart sold below cost in order to run the pharmacy out of business.

When Wal-Mart came to Conway, Ark., in 1987, Dwayne Goode didn't give it much thought. "I thought they would leave me alone and I'd leave them alone," he said.

After all, Goode's American Drug pharmacy had been in business in Conway since 1966 and had many loyal customers. What could Wal-Mart do to change that?

He found out in 1989, when Wal-Mart began running half-page ads in the local newspaper boasting prices \$5 below cost on important prescription drugs like Tagamet, Dyazide and Dilantin.

"A loyal customer said that she could get a certain drug for \$5 cheaper at Wal-Mart, and then I saw the ad and I just couldn't believe they were selling so low," Goode says. "I lowered the price for her because she had been with me for a long time, but I couldn't lower the prices across the board because I would go out of business."

Prices were so low on some products that Goode began going to Wal-Mart to stock his own inventory.

"They would be selling a 6.4-ounce tube of Crest for 98 cents (which normally sold for about \$1.70)," he said. "So I would go in there and clear their shelf."

When he went to Wal-Mart, he would often see a big board at the front of the store comparing Wal-Mart's lower prices to his store's.

After months of declining business, Goode decided it was time to do a little investigating. He went to Wal-Mart stores in Flippen and Clinton, Ark., two towns where the retailer had little competition, and found that Wal-Mart was selling

products up to 20 to 30 percent higher than at its Conway store.

The "maintenance drugs" that were so important to his business were all priced higher in the towns with less competition.

Tagamet, which was selling for \$59 in Conway, was going for \$65.93 in Flippen and \$65.90 in Clinton. Dyazide cost \$7 to \$8 more in the non-competitive areas, and Dilantin was also priced higher in Flippen and Clinton.

After comparing prices, Goode, along with two other local pharmacists, Jim Hendrickson and Tim Benton, decided it was time to seek legal help.

Under Arkansas' Unfair Trade Practices Act, Goode, Hendrickson and Benton argued that Wal-Mart habitually and systematically sold below cost indefinitely with the intention of putting Goode and the other competitors out of business. Twenty-two states currently have laws protecting against this practice (see box), which is commonly known as predatory pricing.

During the case, *American Drug, Inc., et al. v. Wal-Mart Stores, Inc.*, Wal-Mart argued it was just trying to create business, and that while certain high-selling items were priced below cost, each product line — like health care or beauty products — was above cost allowing the retailer to be profitable even in the short run.

Following a two-day trial last October, Faulkner County Judge David Reynolds found in favor of the pharmacies. In the decision, he cited six reasons:

1. The number and frequency of below-cost sales.
2. The extent of below-cost sales.
3. Wal-Mart's stated pricing policy — "meet or beat the competition without regard to cost."
4. Wal-Mart's stated purpose of below-cost sales — to attract a disproportionate number of customers.
5. The in-store price comparisons of products sold by competitors, including plaintiffs.
6. The disparity between Faulk-

ner County prices of the relevant product lines and prices in other markets with more or less competition.

While Wal-Mart plans to appeal the Conway decision, other pharmacies are lining up to get their crack at the retailer.

Steven LaFrance will go to trial in Pine Bluff, Ark., in August on a case his lawyer, Terry Wynne, believes is "an identical case" to the *American Drug* case. LaFrance echoes Goode's rationale.

"Our decision was based on our belief that Wal-Mart is trying to run us out of business," LaFrance says. "We went to other small towns like Dumas, Ark., where there is no competition left, and compared prices. Prices were much higher in the towns with no competition."

Paul Breaux, a lawyer for the Louisiana Pharmacists Association, also believes he has some clients ready to file suit individually against Wal-Mart, but says they are waiting to see what happens with Wal-Mart's appeal in the *American Drug* case.

Pharmacists seem to have the most interest in suing because they tend to have the best cases, says Kelly McCabe, who was the lawyer for the plaintiff in the predatory pricing case in Colorado. "It is very easy to prove a retailer is selling below cost because manufacturers' prices tend to be very set," he says.

While pharmacists believe they have strong cases against the retail giant, some academics, who believe below-cost laws hinder free trade, question the validity of these statutes.

"There are a number of problems with the Arkansas law and below-cost laws like it," says Northwestern University law professor Keith Hylton in Chicago. "There is some uncertainty what rate of return is appropriate to say they are below cost."

Each state law varies in its interpretation of below-cost. The definition ranges from below invoice cost to a minimum markup that is be-

low operating costs but 6 to 8 percent above invoice.

"Another problem is that you ought to allow free trade," Hylton adds. "Companies should be able to bring in more customers temporarily if they want to bring in business."

Goode's lawyer, Matthew Adlong, agrees with Hylton, but argues that Wal-Mart, with almost 2,000 stores, wasn't offering short-term sales to increase business as is the practice of "loss leaders." Instead, the store planned to sell below cost for as long as it had competition.

"This case [in Conway] does not eliminate loss leaders," Adlong says. "A traditional loss leader will put something on sale for a loss for a period of time and then switch the product. What Wal-Mart was trying to control was the pharmacy industry. They would take key products like heart medicine and charge below-invoice price indefinitely."

Charles Shipley, Wal-Mart's lawyer in *Snyder v. Wal-Mart Stores Inc.*, in Hominy, Okla., believes that below-cost laws should be found unconstitutional because "these laws have a chilling effect on free trade."

However, since the *Snyder* settlement, plaintiff John Snyder, who owns Hominy Rexall Drug, believes that there has been fair competition. "When they began to follow the law, my business continued to grow as did theirs," Snyder says.

Kenneth Wilson, owner of Wilson Pharmacy in Cortez, Colo., and plaintiff in *Wilson Pharmacy, Inc. v. Wal-Mart Stores Inc.*, also says that business is back to normal since Wal-Mart raised its prices last March as part of a settlement with Wilson.

Iowa State University professor Kenneth Stone, who has been studying Wal-Mart since 1987, believes the retailer has no plans to make any radical changes in light of these lawsuits. In fact, he says that with Wal-Mart's plans for continued expansion, more and more

small businesses might sue.

"Wal-Mart has a saturation strategy. When they first started, they would place their stores very far apart and make people drive up to 60 miles to go to a Wal-Mart. Now they are beginning to fill gaps," he says. "They are putting stores within 15 miles of the older stores that will put the retailer in direct competition with more small businesses. I wouldn't be surprised if the number of lawsuits increases."

Stone's research shows that Wal-Mart commands control of its market, with as much as 12 percent of small businesses in competition with the retailer folding in 1988.

Nevertheless, he says the Conway decision has affected the way Wal-Mart does business.

"In front of Wal-Mart stores they usually have a kiosk with weekly comparisons with their competitors' prices," he says. "Since the Conway decision, Wal-Mart just shows its own prices. It is like their lawyers told them they had to stop (comparing)."

But Wal-Mart will continue to make sure that it is never undersold on the items that bring the customers into its stores.

"Wal-Mart stores generally have about 80,000 items," Stone says. "A vast majority of these items are the

same price across the country and are pretty high, but each Wal-Mart store will have 500 to 600 items that they will never be undersold on. Wal-Mart is very sophisticated in analyzing the frequency of sales. It knows what is hot."

Northwestern professor Hylton says that the plight of these pharmacies is just one more step in the changing dynamics of business.

"We faced similar questions in the '50s and '60s when supermarkets put mom and pop grocery stores out of business," he says. "There will be a transition, but most customers look at that and feel they are better off."

## States with below-cost statutes

Sales-below-cost statutes vary in definition from state to state. Thirty-two states have at some time had a statute that protects against below-cost pricing with the purpose of running competitors out of business. Currently, 22 states have such statutes.

**Where:** Arkansas, California, Colorado, Hawaii, Idaho, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, West Virginia, Wisconsin and Wyoming.

**When:** Most states passed these laws during the late 1930s and early 1940s.

**Why:** The sales-below-cost statutes "uniformly" state that selling consistently below cost is an unfair practice because it injures competitors and destroys competition. The definition of below cost varies from state to state. It ranges from below-invoice cost to a minimum markup that is below operating costs but 6 to 8 percent above invoice.

**What:** According to Northwestern Law School professor Keith Hylton, the plaintiff must show, "That the defendant charged below cost, and then show with objective reasonableness that it is likely that the defendant tried to destroy its competitor. To prove this, the plaintiff should show that the entry barriers to the market were high. Also, the plaintiff must show that it is a highly concentrated market. Finally, there must be proof that the defendant had some success in running the business out of town.

"If the defendant has 20 competitors and they have been in business for three years and the defendant hasn't forced any competitors out of business, then it will be hard to prove that the defendant engaged in predatory pricing," Hylton says.

**Exemptions** The defendant can sell below cost under the law if:

- It is a clearance or liquidation sale. (21 states)
- The merchandise is perishable. (19 states)
- The merchandise is imper-

fect, damaged or discontinued. (21 states)

- It is an isolated transaction, not in the usual course of business. (four states)
- The merchandise is sold to a charitable or relief organization. (11 states)
- The merchandise is sold to government under contract. (13 states)
- The merchandise is sold by an officer under court direction. (21 states)

A merchant can also sell below cost if the price is set in good faith to meet the:

- existing price of a competitor; (four states)
- legal price of a competitor; (16 states)
- competitor's price on the same product. (11 states)
- competitor's price on product of comparable quality (three states)

(Sources: Keith Hylton, Northwestern University professor of law. *State Sales-Below-Cost Laws: A Legal-Economic Analysis of Effectiveness*, by Thomas W. Paterson and Willard F. Mueller. *Working Paper Series*, University of Wisconsin-Madison, September 1984.)

# Breaking the brokers

In July of 1991, Michael Loehr, an independent sales representative based in Dallas, was hired by Bowman Apple Products to help negotiate a contract with Wal-Mart. When it came time to put the deal together, Loehr, who also owns a food trading company, dropped everything to go down to Wal-Mart's corporate headquarters in Bentonville, Ark.

When Loehr and the Bowman Apple delegation entered the office, a Wal-Mart representative's first remark seemed simple enough: He wanted everyone to identify themselves.

But the mood of the meeting changed as soon as Loehr explained that he was a hired sales broker. The Wal-Mart team insisted that Loehr leave and told Bowman that the apple juice company would have to keep all communications confidential.

Bowman, fearful of losing Wal-Mart as a buyer, agreed to the retailer's request and went about doing business without Loehr — despite a contract.

The sales representative immediately sought legal help. He sued Bowman for breach of contract and won a \$500,000 verdict this past November. He has also filed suit against Wal-Mart in the Eastern District Court of Texas (federal court) for interfering in his contract with Bowman. Galen Watje, a Minnesota lawyer who represents Loehr in both cases, expects a decision similar to the Bowman suit.

"I don't see any reason why a jury would find Wal-Mart less culpable than Bowman," he says. "Wal-Mart must be a little nervous. Its lawyers were in the courtroom (for the Bowman case)."

Wal-Mart's general counsel, Robert Rhoads, said, "I don't make it a practice to talk about pending

litigation."

Like some small business owners (see the main story), independent sales reps, also known as independent brokers, allege that they are losing their jobs because retailers like Wal-Mart are successfully pressuring manufacturers to fire them — even when they have binding contracts.

If Wal-Mart forces a company to break a contract with an independent sales representative, Wal-Mart can be sued under tortious interference law, Watje says.

"In order to successfully sue under tortious interference law, you must prove four things," Watje says. "They are proof: that there is a contract, that the defendant knew about the existence of the contract, that interference has occurred, and that damages to the plaintiff occurred."

While Wal-Mart contends it is not trying to run small businesses out of town, the company has publicly stated that it wants independent sales representative out of its business. Independent sales reps are brokers for hire. Smaller companies that do not have the resources to maintain a full team of representatives will take on an independent broker to work with certain large retailing companies.

On Nov. 6, 1991, Wal-Mart made it clear that they no longer wanted to deal with this independent force. In a letter to manufacturers, Wal-Mart CEO David Glass flatly said that Wal-Mart had "decided that our dealings should be directly with the principals of your company." This decision meant the huge retailer wouldn't deal with any independent reps because, according to Glass, Wal-Mart could no longer be involved in dealings with brokers who "claim to be a 'principal' of one or more other companies."

While Wal-Mart has the legal

right to ask manufacturers to deal directly with it, Wal-Mart's tactics have been questioned. According to Watje, who along with representing Loehr has another case pending against Wal-Mart, the retailer has been strong-arming manufacturers across the nation.

"Since that letter in November of '91, I have been contacted by 120 reps who were interested in legal action over the Wal-Mart decision," Watje says. "The irony is that most of these independent reps are still selling with Wal-Mart. Wal-Mart has been very slippery in that they have been easing independent reps out, waiting for the statutes of limitations (to file suit against the company) expire before they get rid of them."

Watje has a case similar to Loehr's pending against Wal-Mart, but says his client has asked that his identity not be revealed so that other contracts would be protected.

The reason there have not been more cases, according to Jack

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## *The brokers are afraid.*

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Springer, director of the National Association of General Merchandising Representatives, is that brokers are afraid.

"Most (independent) sales reps don't want to go to court against their customers or buyers," Springer says. "They don't want to lose what business they have."

Watje agrees: "I had one rep who contacted me with a great case. Wal-Mart had interfered with four of his five contracts with manufacturers. But the fifth contract was with Wal-Mart, so he didn't want to take legal action even though recovery would have been substantial."

Another problem is that when reps finally have lost everything and are ready to sue, they often don't have enough money to cover legal fees, Watje says.

Like the brokers, the manufacturers are also afraid to stand up to Wal-Mart. According to Tom Conley, director of the National Housewares Manufacturing Association, which represents both manufacturers and some independent reps, most smaller manufacturers have no choice but to follow Wal-Mart's wishes if they want to keep its business.

"For a great many small businesses, independent reps are absolutely critical," Conley says. "There are manufacturers who say they would like to keep the reps, but they realize that the chance of losing Wal-Mart is not worth it."

Kenneth Stone, a professor at Iowa State University who wrote a study on Wal-Mart's effect on

local businesses, *When Wal-Mart Comes to Town*, supports the retailer's right to phase out the independent brokers.

"I am not too sympathetic with the reps," Stone says. "Wal-Mart's point is that they want to be as efficient as possible, and with their very efficient distribution system they can and should deal directly with the manufacturer."

Wal-Mart says cutting out the reps is necessary to improve efficiency. "The improved communication and increased reaction time will enhance both our businesses since we can react more quickly to both our needs," Glass wrote to manufacturers in the 1991 letter. "To attempt to accomplish all this through a third party would be virtually impossible and run a high risk of misunderstanding or slow reaction to opportunities or problems."

As for the future, prospects look

bleak for independent reps. Wal-Mart has continued to pressure manufacturers to do away with outside brokers. Once manufacturers cut contracts with the independent brokers, the brokers no longer have a basis to sue Wal-Mart.

Some independent reps have banded together to press the government to take action against Wal-Mart and other large retailers that pressure manufacturers to drop brokers.

An organization called the Coalition of Americans to Save the Economy (CASE) has filed a request with the Federal Trade Commission to investigate Wal-Mart and is lobbying Congress to amend the Robinson-Patman Act, a federal antitrust law. The amendment would give independent sales reps standing to sue buyers which, in the course of eliminating independent brokers, receive concessions or kickbacks from the manufacturer.

The FTC would neither deny nor confirm that it was investigating Wal-Mart, and CASE's proposed legislation had only one public congressional supporter, Rep. Lamar Smith, R-Texas.

Watje believes that while CASE's heart is in the right place, all the legal means necessary to sue are currently in place.

Conley, of the National Housewares Manufacturing Association, says that the only way independent brokers will survive is if they adapt to the times.

"Reps are going to have to change and redefine their role. They are going to have to become more literate in the commerce communication link (like distribution)," he says. "They will need to take fewer contracts (with manufacturers) in order to do a better job with the lines they stay with. Basically, they are going to have to become experts in representing the lines they keep."

— Josh Chetwynd

