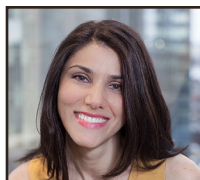

What Consumers Really Think About Reference Price Labels

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We have all encountered reference prices while shopping. For example, in a retail pharmacy setting, consider a \$6.49 generic over-the-counter medication that appears similar to the \$8.99 branded version sitting next to it on the shelf. Consumers may view the \$8.99 as a “reference price” for the generic product and perceive that purchasing the generic is a good deal because it will result in “saving” \$2.50.

Retailers, particularly “discount retailers,” often take this concept further. Many present a “compare at” or “original” price (or even just a crossed-out number next to the actual selling price) and calculate a dollar or percentage difference in savings for the consumer (e.g., “save \$2.50”).

Academics have studied such explicit reference prices, as well as less obvious, more internal reference prices (e.g., the price that the consumer expects before walking into the store, or the highest price the consumer is willing to pay for the product).¹

Recently, retailers’ practice of using reference prices has come under legal scrutiny. Numerous class actions and government cases have been brought against both online and brick-and-mortar retailers in this context, frequently under California’s consumer protection laws.

It has been alleged, for example, that advertised reference prices are “artificial, arbitrary and did not represent a bona fide price at which [the defendant] formerly sold,” which effectively “misrepresented the existence, nature and amount of price discounts” for consumers.²

Indeed, the Los Angeles city attorney filed similar complaints in its recent lawsuits against JC Penney, Macy's, Kohl's and Sears. These cases hinge on whether and how the reference price presentation impacts consumer perceptions and behavior.

Investigation into these and related questions invites empirical research. Below we examine such research, in the context of both the courtroom and academia.

Recent Developments in Reference Pricing Litigation

The defendants in reference price cases are often discount retailers and outlets, where all products presumably are being sold at a discount. Lawsuits against outlet stores often allege that in-store advertisements for outlet products imply a discount relative to mainstream retail prices, but that some of these products were never actually sold in mainstream retail.

Lawsuits against retailers typically allege either that the retailer misrepresented the "original" price of a good that is "on sale," or that the retailer misrepresented a "compare at" market price for the good.

Legally, a retailer is required to provide an explicit definition of its reference price. For example, in *Staci Chester et al. v. The TJX Cos. Inc. et al.*, the U.S. District Court for the Central District of California determined that "a link at the bottom of a webpage and a sign near the return counter, not the sales counter, will not suffice" to clearly communicate reference price definitions to consumers, and has thus far denied efforts to dismiss the case.³

Without clear definitions, consumers allegedly are led to believe that the "compare at" price is the prevailing department store price for that product, when, in fact, that is not the case.

Lawsuits against e-retailers follow a similar pattern. Retailers such as Amazon and Overstock.com have been sued for offering purported savings relative to a "compare at" estimated retail price. Plaintiffs claim that in reality such prices are either the highest price the good has ever sold for in an online marketplace or the result of an arbitrary multiplier being applied to the current selling price.⁴

While the suit against Amazon was dismissed on the basis of the terms and conditions agreed upon by Amazon customers during checkout, *People of California v. Overstock.com* resulted in a decision against the e-retailer and, along with *Rubenstein v. Neiman Marcus*, helped set a precedent for subsequent deceptive pricing litigation.

Case outcomes to date have shown a focus on the "reasonable consumer's" perception of the label accompanying a reference price. In *Branca v. Nordstrom*, claims that "reasonable consumers" were misled by reference price labels were substantiated by a consumer survey, and the case has moved past the preliminary stage.⁵

In the Overstock decision, specific guidelines were provided for reference price labeling. Together, these case outcomes have cemented consumer interpretation of the

reference price label — and whether it is misleading — as the primary point of contention in reference price cases.

The case outcomes also suggest that courts will not generalize the perceptions offered by the plaintiffs (e.g., based on just one named plaintiff) and prefer to rely instead on primary data (e.g., surveys).

Academic Research on Reference Prices

Academics have long been interested in reference prices. In fact, Daniel Kahneman received his Nobel Prize in 2002 in part for a seminal series of papers on reference prices, and on reference points more generally.⁶ Numerous findings and theories followed this original research.

For example, Richard Thaler found that consumers are generally willing to pay less for the same good at a corner bodega than from a hotel.⁷ He hypothesized that consumers derive utility from both the acquisition of a good and the perceived financial quality of the deal, calling the latter the “transaction utility” of the purchase.

A reasonable consumer might expect to pay \$6.00 for a beer at a hotel, which makes a \$4.50 beer seem like a good deal. In this case, the consumer would enjoy both the acquisition of a cold beer and the knowledge that she secured a good deal. In contrast, paying \$4.50 for a beer at a corner bodega might seem like a rip-off, where an expected price might be closer to \$3.00.

The deal would result in the same enjoyment from acquiring the beer, but the negative transaction utility from the perceived rip-off might leave a sour taste in the consumer’s mouth or discourage her from making the purchase altogether.

Note that, in this context, reference prices are not necessarily provided by the retailer, but may be generated internally by a consumer based on prior experiences and knowledge of the market.

The internal reference price underlies consumer decisions and is thus of utmost interest to academics. The internal reference price is driven both by a consumer’s prior experiences, such as how much a similar product would cost in a non-outlet store, and by external reference prices provided by retailers, such as a price tag that says “compare at.”

External reference prices can be conveyed in many ways: “original,” “MSRP” (manufacturer’s suggested retail price), “list price” and “compare at” are just a few of the labels used by retailers. Whether there is a difference among any of these labels in terms of how consumers react to them has also been the subject of academic research.

Larry Compeau and other researchers found that different consumers interpret labels such as “regular price,” “MSRP” and “compare at” in different ways.⁸ These researchers point out that, even if a certain label appears misleading, consumers will not necessarily take the label’s language at face value.

For example, while 50 percent of respondents in their study interpreted “compare at” as the “usual” price of the item, 31 percent interpreted “compare at” as a meaningless

inflated price. Similar questions have also been addressed in litigation surveys (e.g., *People of California v. Overstock.com*, *Branca v. Nordstrom*).

Experimental Approach for Litigation: Does the Reference Price Label Matter?

The key question asked in litigation to date has been, “How would a reasonable consumer interpret X?” The instructions for reference price labeling outlined in *People of California v. Overstock.com* assume both that reasonable consumers will have uniform, accurate interpretations of the legally accepted labels and that they will be uniformly deceived by labels that violate the guidelines.

But of course the definition of a “reasonable consumer” is vague, varies by court and is partly dependent on how many consumers have to interpret X in a particular way for it to be deemed “reasonable.” Ultimately, to prove that a label caused harm, one would need to demonstrate that changing the label to comply with the “instructions” provided by the court actually mattered (or was “material”) to consumers.

If consumers’ purchasing behavior or perception of the reference price remained the same after changing the label, it would suggest that the initial label caused no harm, even if some consumers interpreted the initial label as misleading.

A research study can be designed to assess whether consumers would interpret the allegedly deceptive label any differently than one that complies with the instructions from the court. Such a study could be mocked up in a survey or carried out in a real purchase setting.

For example, consumers exiting a store or an online retailer’s website could be invited to answer a few questions about the experience. Prior to such questioning, participants would be randomly assigned to encounter either the allegedly misleading label (e.g., “compare at” or “original”) or a label that explicitly fits the Overstock guidelines, such as “compare estimated value.”

After reviewing the labels and perhaps experiencing the online retail website or physical retail store firsthand, respondents would be asked carefully designed questions about their interpretation of the reference price. If the answers are similar regardless of the label, one could conclude that the allegedly misleading label caused no harm to consumers.

An alternative study design would be to record consumers’ actual purchases without them knowing that they are part of an experiment. The researcher could then evaluate whether consumers purchase different amounts or different products depending on whether a product’s reference price is labeled as, for example, “compare at” versus “compare estimated value.”

This measure is compelling for two reasons. First, it speaks directly to the “materiality” of the reference price label. Second, it has high “external” validity because, since purchases are measured directly, there is no question of whether the findings are

“generalizable” to the “real world.” Such field experiments conducted online even have a special name: “A/B tests.”

As in other areas of litigation (e.g., trademark infringement, and false advertising cases not related to reference prices), empirical research can be very valuable in helping to resolve disputes. Consumer surveys and/or field experiments can provide insight into how consumers might interpret and respond to various reference price labels.

As litigation on reference prices continues to gain momentum, these types of studies are likely to have a more prominent role in determining case outcomes.

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Endnotes

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