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DC Circuit Rules in FTC's Favor on Whole Foods-Wild Oats Merger

A divided panel of the DC Circuit Court of Appeals this week overturned a district court decision that paved the way for Whole Foods Markets to acquire competitor Wild Oats Markets nearly one year ago. *FTC v. Whole Foods Market, Inc.*, No. 07-5276 (D.C. Cir. July 29, 2008). The Court of Appeals ruled that the district court had erred in determining that the relevant product market consisted of all supermarkets, and had failed to account for evidence offered by the Federal Trade Commission ("FTC") to show that Whole Foods and Wild Oats were direct competitors in a market composed of "premium, natural, and organic supermarkets." On this basis, the Court of Appeals reversed the district court's order denying the FTC's request for a preliminary injunction.

In February 2007, Whole Foods announced that it would acquire Wild Oats for $565 million. Following an initial investigation, the FTC filed an action in district court to block the merger temporarily while it conducted an administrative proceeding to determine the combination's impact on competition. The premise of the FTC's argument in court was that Whole Foods and Wild Oats were the two largest (and, in some geographic areas, the only) competitors in a distinct market – so-called premium, natural, and organic supermarkets. Their merger, the FTC maintained, would thus result in a monopoly for this market.

The district court denied the FTC's request for a preliminary injunction, rejecting its proffered market definition and concluding that the FTC had offered no basis for inferring that the merger would lead to a reduction in competition among supermarkets overall. The Court of Appeals subsequently denied the FTC's emergency motion for an injunction pending appeal, and, on August 28, 2007, the parties consummated their transaction.

The Court of Appeals held, as an initial matter, that the fact of the merger's consummation did not strip it of jurisdiction to decide the FTC's appeal of the district court's ruling. Proceeding to the merits, the Court concluded that while the district court was correct in determining that the FTC's case hinged on the definition of the relevant product market, the district court erred in concluding that the FTC had failed to show a likelihood of success in proving that the relevant product market was the one it had alleged – premium, natural, and organic supermarkets.

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Crucial to the Court's decision was a distinction originally drawn by the district court between "marginal" and so-called "core" or "committed" consumers. While the district court held that antitrust analysis must focus on marginal consumers in assessing the likelihood of harm to competition, the Court of Appeals held that "core consumers can, in appropriate circumstances, be worthy of antitrust protection." Though Whole Foods and Wild Oats each may have competed against conventional supermarkets for certain fringe products and certain fringe customers, the Court found that the FTC had put forth substantial evidence showing that both companies served a base of core customers for whom shopping at a general supermarket was not a reasonable alternative. In this regard, premium, natural, and organic supermarkets were, in the Court's view, akin to office superstores – which the district court had previously held constitute a separate product market, despite the fact that aspects of their inventory overlap with that of other types of stores.[1]

The Court found three categories of evidence offered by the FTC to be especially convincing with regard to product market definition. First, the Court highlighted the use of a "critical diversion" analysis by the FTC's expert economist to calculate the average loss of customers that would result if a hypothetical monopolist in premium, natural, and organic supermarkets tried to raise its prices. This approach differed from the more conventional "critical loss" analysis employed by Whole Foods's expert, which (according to the Court) focused "only on the *marginal* loss of sales" and thus ignored the impact on core consumers.

Second, the Court credited evidence compiled by the FTC's expert to show that in geographic areas where Whole Foods faced competition from Wild Oats, its profit margins on "high-quality perishables" were lower than in other areas. According to the Court, such products accounted for 70% of Whole Foods business, and were a unique focus of premium, natural, and organic supermarkets.

Third, the Court cited evidence based on Whole Foods internal projections and market research suggesting that if a Wild Oats store located near a Whole Foods store were to close, most customers would switch their business to Whole Foods as opposed to any other supermarket. This evidence, the Court indicated, was consistent with the idea that for core customers, Whole Foods and Wild Oats were not interchangeable with conventional supermarkets.

The Court of Appeals concluded that the district court had ignored the FTC's evidence distinguishing between core and marginal consumers, and suggesting that Whole Foods would have the ability to price discriminate between these two groups. Based on such evidence, the Court held that the FTC had demonstrated a likelihood of success sufficient to balance any public and private equities that might weigh against issuing a preliminary injunction. The Court remanded the case for the district court to conduct this balancing before determining whether to issue an injunction.

The dissent characterized the majority's decision as a "judicial about-face" from the Court's decision a year ago to deny an injunction pending appeal, and argued vigorously that the district court had reached the correct result in refusing to enjoin the merger. The dissent agreed

1 *See FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

that the dispositive issue on appeal was market definition, but maintained that the FTC had committed the "basic antitrust error" of confusing product differentiation with separate product markets. The fact that Whole Foods and Wild Oats had differentiated themselves from conventional supermarkets in largely the same way did not, the dissent reasoned, mean that they were not still in competition with conventional supermarkets. Most significantly, the dissent faulted the FTC for failing to identify any evidence that Whole Foods's prices (as opposed to its margins) were directly affected by competition from Wild Oats, or that the merged entity could sustain a price increase without losing significant numbers of customers to conventional supermarkets. In the dissent's view, the FTC's arguments for blocking the transaction hearkened back to "the bad old days when mergers were viewed with suspicion regardless of their economic benefits."

The practical impact of the DC Circuit's decision in *Whole Foods* is far from clear. Should the district court determine on remand that an injunction is warranted, both the court and the agency will have to confront the fact that Whole Foods has already sold, shut down, or converted several Wild Oats stores since the deal closed. As a result, fashioning an appropriate remedy for any anticompetitive impact from the transaction may be difficult.

The DC Circuit's concern for protecting "core" as opposed to "marginal" consumers has the potential to impact merger analysis in a wide variety of other industries. This approach would be contrary to the way both the FTC and DOJ have done market definition and merger analysis for decades. All prior analysis focused on the marginal customers (of whatever market was in question including markets subject to price discrimination) and whether or not there were sufficient numbers of marginal customers to protect the others. It thus remains to be seen how broadly the FTC, as well as the Department of Justice Antitrust Division and courts in other circuits, will seek to apply this distinction in future cases.

Finally, the majority as well as the concurring opinion both raise questions regarding the manner in which critical loss analysis was applied in this case (perhaps simply a function of the core vs. marginal customer issue described above), but it is unclear whether those criticisms will alter the way critical loss analysis is applied in the future. At the very least, these opinions indicate the Court's willingness to entertain alternative modes of economic analysis – such as the "critical diversion" approach employed by the FTC's expert witness – in evaluating merger challenges. Although at a very basic level, critical loss and critical diversion are both seeking to answer the same question – whether a potential price increase from the merger would be profitable.

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