

Whole Foods Ruling: A Template for Mergers

Friday, Sep 07, 2007 --- On August 21, 2007, the District Court for the District of Columbia released its decision denying the Federal Trade Commission's ("FTC") motion for a preliminary injunction to halt the merger of Whole Foods Market ("Whole Foods") and Wild Oats Markets, Inc. ("Wild Oats").

The Whole Foods decision stands in contrast to the FTC's success ten years ago when it prevented the merger between Staples and Office Depot. (Federal Trade Commission v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997).)

As is often the case, the relevant market issue was paramount to the outcomes in both Whole Foods and Staples.

In Whole Foods, the court rejected the FTC's narrow market definition, whereas in Staples it accepted the FTC's narrow market definition.

In resolving this critical issue, the court relied on "hard" evidence such as pricing data, economists' analyses, and information provided by third parties.

This same evidence also showed that the merger was unlikely to impact competition significantly.

Comparing the opinions in the Whole Foods and Staples cases provides useful insights into how courts may resolve product market definition in merger cases involving "differentiated" products (i.e., products that consumers perceive as different although they perform the same basic functions).

* Case Background *

The FTC challenged the Whole Foods/Wild Oats transaction because it believed the merger would substantially lessen competition in the alleged market for "premium natural and organic supermarkets."

The FTC already had moved for and was granted a temporary restraining order, preventing Whole Foods and Wild Oats from consummating their transaction.

Subsequently, on July 31 and August 1, the court held a hearing on the FTC's motion for preliminary injunction. After considering the arguments presented at the hearing, testimony from each side's economists, expert reports, numerous declarations from the parties and other third parties, and various documents, Judge Paul Friedman issued an order and 93-page

opinion denying the FTC's motion for preliminary injunction approximately two weeks after the conclusion of the hearing.

The FTC sought a stay, which would have prevented the parties from completing the transaction, pending an appeal before the Court of Appeals for the District of Columbia. The Court of Appeals refused to issue a stay on August 23. Whole Foods subsequently consummated the transaction on August 28.

* Factors Relied on in Rejecting FTC's Narrow Product Market in Whole Foods *

In Whole Foods, the FTC identified several features that allegedly distinguish "premium natural and organic supermarkets" from conventional supermarkets, and supported a separate market.

According to the FTC, "premium natural and organic supermarkets" generally: focus on "high-quality perishables, specialty and natural organic produce, prepared foods, meat, fish and bakery goods," have "high levels of customer services," "target affluent and well educated customers," are "mission driven with an emphasis on social and environmental responsibility," "provide customers with the confidence of a 'lifestyle' brand," and "provide a 'unique' environment."

Applying the FTC and Department of Justice's ("DOJ") Horizontal Merger Guidelines, the District Court found that the FTC's proposed market of "premium natural and organic supermarkets" was too narrow, and that the relevant market "inevitably" encompassed at least all supermarkets. The basic facts the court relied on included:

* Event studies / pricing data *

There was no significant economic proof that prices were lower in areas where Whole Foods and Wild Oats were both present (as opposed to only one of them being present). Also, there was no strong evidence that entry of a second "premium natural and organic supermarket" into an area had any impact on prices.

* Cross-shopping *

With conventional supermarkets increasing the number of natural and organic products they offer, the court found that many of Whole Foods' and Wild Oats' customers could and did exercise shopping alternatives regularly by cross-shopping among various supermarkets and retailers, looking for the best prices in fulfilling their shopping needs.

The high incidence of cross-shopping demonstrated that price-sensitive customers have the simple choice of buying the products they would buy at Whole Foods or Wild Oats wherever they do the rest of their shopping.

In other words, “premium natural and organic supermarkets” are not only competing with themselves, but with conventional supermarkets as well.

* Company competitive plans / strategies *

The company and third party testimony and materials cited by the court demonstrated that Whole Foods faces significant competition from conventional supermarkets.

The testimony from third parties, i.e., conventional supermarkets, showed they were repositioning their stores to compete more effectively with Whole Foods.

There was no evidence that Whole Foods uniquely competed with Wild Oats, or that the firms competed with each other differently than they competed with conventional supermarkets.

For example, Whole Foods and Wild Oats are not pricing solely against one another. Whole Foods priced based on grocery stores and not based on Wild Oats. In addition, Whole Foods price checked against conventional supermarkets (and vice versa), but generally not against Wild Oats.

* Customer draw / loss patterns *

The court also found that the stores primarily drew business from conventional supermarkets, rather than from each other, when entering a new area.

In light of this evidence, the court concluded that the FTC’s proposed product market was not appropriate. Applying the Merger Guidelines SSNIP (price increase) test, the court found that a small price increase by “premium natural and organic supermarkets” would be unprofitable, because customers could readily shift purchases to other stores.

The court found that the FTC improperly equated the unique characteristics of Whole Foods and Wild Oats stores with a unique relevant product market.

The court noted that there may well be differences between conventional supermarkets and “premium natural and organic supermarkets,” but the relevant question was whether enough customers would switch to conventional supermarkets if Whole Foods, post-merger, were to raise prices or reduce quality.

* Factors Relied on in Accepting FTC’s Narrow Product Market in Staples *

A comparison with Staples is instructive because the issues were similar, but the proof and outcome were different.

The FTC argued that the proposed merger of Staples and Office Depot would substantially lessen competition in the market for “the sale of

consumable office supplies through office superstores.”

As in Whole Foods, the FTC identified unique characteristics that differentiated office supply superstores from other retailers, for instance, distinct store formats, different sets of customers, and dissimilar pricing; however, unlike in Whole Foods, the FTC presented significant pricing data and other evidence in support of its proposed market definition.

In Staples, the court agreed with the FTC’s assertions, relying on the following evidence:

* Event studies / pricing data *

Unlike in Whole Foods, the FTC presented strong pricing data in Staples, which demonstrated that in areas where Staples was the only office superstore, its prices were 13% higher than in areas where there was also an Office Depot or Office Max.

In areas where Office Depot was the only office superstore, its prices were more than 5% higher than in areas where other office superstores existed.

Despite the presence of other retailers (such as Wal-Mart and Best Buy) in Staples-only or Office Depot-only markets, Staples and Office Depot still consistently charged higher prices than in markets where there were two or three office superstores.

The FTC also presented evidence that when another office superstore entered a one-firm market, the incumbent office superstore lowered its prices, whereas it did not respond to entry by other non-office superstore retailers.

* Unique characteristics *

While not dispositive by itself, when considered in tandem with the other evidence the FTC presented, the court found that the unique characteristics of office superstores distinguished them from other retailers.

Office superstores are large in size and scale and devote more floor space to consumable office supplies than other retailers.

Also the customer base of office superstores (primarily small businesses and consumers with home offices) differed from the customer bases of other retailers and mail order firms.

* Company competitive plans / strategies *

Unlike in Whole Foods, there was significant evidence that Staples and Office Depot uniquely competed against one another.

Staples’ and Office Depot’s internal documents showed that the merging

companies (and Office Max) regarded only other office superstores as their competition, making business decisions vis-à-vis other office superstores and not other retailers and mail order firms.

Staples' internal business documents also confirmed that its localized zone pricing policy called for higher prices where it was the lone office superstore than in those geographic markets where it faced competition from other office superstores.

Also, Staples and Office Depot price checked against other office superstores far more frequently than they price checked against other retailers.

* Lessons Learned *

The contrast between the FTC's success in Staples versus the outcome of the Whole Foods case provides important guidance for determining whether the courts will enjoin (at least preliminarily) a particular transaction or not.

* Company Documents *

Company "hot" documents are a good indicator of whether the FTC or DOJ will investigate a particular transaction, but will not necessarily doom a transaction when reviewed by a court.

The FTC's Whole Foods complaint is peppered with sound bites from documents prepared by Whole Foods' CEO John Mackey. For example, Mr. Mackey wrote to his Board of Directors, "By buying [Wild Oats] we will . . . avoid nasty price wars." To be sure, the Whole Foods documents revealed by the FTC at the preliminary injunction hearing were not helpful to Whole Foods, but the court placed more weight on a variety of other important evidence, such as pricing data, evidence from third party conventional supermarkets, and economic analysis.

* Pricing Data *

The FTC could not show a significant price effect in Whole Foods, which ultimately doomed its case. This is because in order to satisfy the SSNIP test, whether at the 5% or 1% level, the FTC had to show that a combined Whole Foods and Wild Oats would have been able to impose a price increase in order to prove its market.

In addition, the lack of a price effect also showed that the Whole Foods transaction, no matter what the market definition, would not have resulted in a significant adverse effect on competition.

In Staples, the actual data demonstrated the significant impact Office Depot and Staples had on each other's pricing, and how prices were substantially lower where they were in competition.

In Whole Foods, there was no such relationship between Whole Foods and Wild Oats pricing.

* Dynamics of Competition *

In Whole Foods, significant data, testimony and documents confirmed that substantial conventional supermarkets were acutely focused on emulating and competing with the Whole Foods brand and image.

In addition, there were many “event studies” present in Whole Foods where entry by Wild Oats in Whole Foods markets (or vice versa) had no impact on the incumbent’s pricing.

This was in stark contrast to the evidence in Staples, where the existence of both Staples and Office Depot in a particular area had much lower pricing than in areas where only one was present.

* Customer Behavior *

In Whole Foods, evidence showed that many customers switched purchases, either in part or completely, between conventional supermarkets and the merging parties.

While there may be “core customers” who shop only at Whole Foods, most customers spread their purchases among multiple stores.

This behavior is important because it meant that many customers could align their purchases with the less expensive or higher quality store and force all stores, including conventional supermarkets, to compete for more revenue from these marginal customers.

In Staples, the overwhelming majority of Staples’ and Office Depot’s customers purchased their office supplies only from office superstores, which included only the two parties and Office Max.

The Whole Foods transaction illustrates the importance of developing robust data, not just anecdotal evidence, addressing market definition and competitive effects under the Merger Guidelines factors and the case law.

The district court’s reliance on economic and behavior evidence underscores the importance of “hard” evidence in evaluating market definition in potential mergers involving differentiated consumer products, as opposed to anecdotal “puffery” contained in business documents.

It still remains to be seen whether the FTC will continue to pursue its challenge to the Whole Foods merger and seek a permanent injunction now that it has been completed, but based on the district court’s 93-page opinion, it appears that the FTC has substantial issues to overcome.

This decision follows a trend of courts in recently litigated cases (such as

Oracle/PeopleSoft; Arch Coal/Triton Coal; Sungard/Comdisco) holding the government to a rigorous burden of proof.

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