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Federal Trade Commission v. Whole Foods Market, Inc. — A View From the Dugout

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The last issue of The Threshold likened the Federal Trade Commission's ("FTC") suit to block the acquisition of Wild Oats Market, Inc. ("Wild Oats") by Whole Foods Market, Inc. ("Whole Foods Market") to one of three baseball pitches swung at by the FTC's Bureau of Competition. As this article goes to publication, the battle for this year's World Series championship has recently concluded so we will stick with the baseball metaphor. Some loyal fans (mostly FTC alumni) sized up the FTC's odds of getting a hit and concluded that the FTC was going to hit a home run. Patterned after FTC v. Staples, Inc., the complaint teemed with references to "monopoly" markets and provocative allegations about the transaction's effects. Yet, the parties dug in, contesting the FTC's view of the market and the competitive realities. The battle lines were drawn and the lineups were set for trial.

The FTC did not prevail. The district court denied the FTC's request for a preliminary injunction, and both the district court and the United States Court of Appeals for the District of Columbia Circuit denied the FTC's emergency motion for an injunction pending appeal. The parties consummated their transaction shortly thereafter. The FTC's appeal from the district court's order remains pending. Whole Foods Market has moved to dismiss the appeal as moot. The FTC opposes dismissal of its appeal. The FTC's administrative complaint remains pending as well, although the administrative case was stayed in August by order of the Commission.

Our perspective is unique. We got called up late, joining a talented team at the top of the seventh inning as Whole Foods Market retained our firm about one week after the FTC issued its complaint. The purpose of this article is not to discuss in depth the judge's decision, which as noted remains on appeal, but rather to provide a hopefully valuable and interesting litigant's perspective on a very significant and widely-reported preliminary injunction proceeding.

"The Prelude to the Game"– The Transaction and The Investigation

Whole Foods Market first opened its doors in 1980 in Austin, Texas as a store focusing on healthy foods. Over time, Whole Foods Market expanded the range of products offered to

[1] The authors represented Whole Foods Market, Inc. during the preliminary injunction hearing discussed in this article, and also are counsel to it in the subsequent proceedings.

attract a broader universe of customers and to increase sales. Its newest stores, at 50,000–60,000 square feet, are comparable in size to other supermarkets. Before the acquisition, Whole Foods Market operated 194 supermarkets in the United States. Wild Oats, another supermarket chain with a historical focus on natural, healthy foods, operated 115 stores in the United States in 2007 under three banners: Wild Oats Marketplace, Henry's Farmers Market, and Sun Harvest. Wild Oats' stores were smaller, averaging about 24,000 square feet.

In February 2007, Whole Foods Market agreed to buy the stock of Wild Oats at a per share price of $18.50, or $565 million. The FTC issued a Second Request on March 13; there were 26 documents and data specifications, including many of the standard requests in the Model Second Request for retail transactions. The FTC did not, however, request any pricing data.[2] In response, Whole Foods Market and Wild Oats produced a total of about 16.5 million pages of documents and over 2.4 gigabytes of data. The FTC also conducted investigational hearings of five employees each of Whole Foods Market and Wild Oats, the former CEO of Wild Oats, and the CEO of Trader Joe's.

On June 6, 2007, after conclusion of the FTC's investigation, the Commissioners voted 5-0 to file suit in the District of Columbia District Court seeking a temporary restraining order and preliminary injunction to prevent Whole Foods Market from acquiring any stock or assets of Wild Oats. With the parties' consent, the court entered a temporary restraining order until the court ruled on the motion for a preliminary injunction.

"The Schedule and the Rules of the Game"

The FTC and the defendants had largely agreed on a schedule for discovery, briefing and trial, as well as the rules under which the preliminary injunction hearing would proceed, before we came on board. Both the schedule and the rules significantly affected litigation strategy.

The agreed-upon Case Management Order ("CMO") called for a preliminary injunction hearing in less than two months. The schedule leading up to the hearing was ambitious but, as it turned out for both sides, manageable.[3] To assist the court, the parties provided expert reports and witness declarations to the court simultaneous with the exchange among the parties. This enabled the court to review the evidence in advance of the hearing and to prepare its own questions for the witnesses and the lawyers at the hearing.

The hearing itself was streamlined. The only testimony presented live was the cross-examination and redirect examination of expert witnesses. The format, therefore, placed a

[2] Specification 5(e) of the FTC's Model Second Request for transactions involving retail industries requests pricing data for the top 2000 UPCs by annual dollar sales. See http://www.ftc.gov/os/2004/04/040428modelrequest.pdf.

[3] The CMO required the parties to exchange final lists of fact witnesses, including a brief summary of their anticipated testimony, on June 27, 2007. Fact discovery closed nine days later, on July 6. Initial expert reports were due on July 9, rebuttal expert reports were due on July 13, and expert depositions were to be taken by July 18. Declarations of fact witnesses were due on July 13. Opening briefs on the motion for preliminary injunction were due on July 20, reply briefs were due by July 25, a two-day hearing was scheduled for July 31-August 1, and proposed findings of fact and conclusions of law were due by August 3.

significant premium on the clarity of declarations, the selection of company documents, and the selection of deposition testimony to highlight to the court.

"The FTC's Lineup"–The Case Against the Transaction

The FTC's case depended on its narrow view of the relevant product market. In a departure from prior merger enforcement involving food retailing,[4] the FTC alleged a product market consisting of "premium and natural organic supermarkets" ("PNOS"). The FTC resisted defining, until compelled by the court, the precise characteristics of participants in the market it alleged. Eventually, the FTC listed ten qualitative attributes that a market participant "generally," but not always, would possess.[5] According to the FTC, only four firms in the entire United States met its definition of PNOS: Whole Foods Market, Wild Oats, Earth Fare (a Southeastern regional supermarket operator), and New Seasons (an Oregon-based operator with less than ten stores in the Pacific Northwest). The FTC relied on two main lines of evidence to support its position, arguing that: (1) company documents, primarily statements by Whole Foods Market's current CEO and statements by Wild Oats' former CEO, showed the existence of a unique and durable competitive rivalry between Whole Foods Market and Wild Oats; and (2) econometric analyses conducted by the FTC's economic expert, Dr. Kevin Murphy, predicted anticompetitive effects if the merger were consummated.

The FTC's case featured statements by Whole Foods Market CEO John Mackey, which have been featured in press reports across the country. For example, in one e-mail, Mackey wrote:

> By buying [Wild Oats] we will greatly enhance our comps over the next few years and will avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm our gross margins and profitability. Furthermore, we eliminate forever the possibility of Kroger, Super Value, or Safeway using their brand equity to launch a competing national natural/organic food chain to rival us . . . . Eliminating them means eliminating this threat forever, or almost forever.[6]

The FTC also featured statements by Wild Oats' ex-CEO as evidence of what the FTC described as "unique" competition between the two firms.

Batting cleanup for the FTC was its economic expert, Dr. Kevin Murphy, the George J. Stigler Distinguished Service Professor of Economics at the University of Chicago. Dr. Murphy testified live at the preliminary injunction hearing in district court. Dr. Murphy purported to show that Wild Oats was Whole Foods Market's closest competitor and that the acquisition of Wild Oats by Whole

[4] A review of the FTC's prior supermarket enforcement matters reveals that in all eighteen of such matters since the adoption of the 1992 FTC Horizontal Merger Guidelines, until this merger, the FTC had concluded that the relevant product market was at least as broad as the retail sale of food and grocery items in supermarkets.

[5] Curiously, however, the FTC offered no principled means of determining whether a store met these criteria, admitting that the stores in the alleged product market would not necessarily possess every attribute or even possess them to the same degree.

[6] FTC Complaint, June 5, 2007, Introduction.

Foods Market would be "unambiguously anti-competitive."

"The Heart of the Defendants' Lineup"–Our Case

The defendants' case focused on market realities as shown by contemporaneous, ordinary course of business records, supported by expert testimony. Defendants contended that this evidence showed that major supermarket operators had recognized and responded to the growth in consumer demand for natural and organic foods by positioning themselves to protect existing market share and expand sales of natural and organic products. At the same time, Whole Foods Market had expanded its stores to reach consumers that may not have historically shopped at Whole Foods Market. Defendants argued that while Whole Foods Market may have started with a mission to sell primarily natural and organic foods, its stores no longer reflected such a singular focus. Rather, a typical Whole Foods Market store today carries about 30,000 stock keeping units, including a wide variety of conventional products. Many of Whole Foods Market's products are not organic, including more than half of its produce and a significant percentage of its prepared foods, baked goods, and specialty items. Thus, while Whole Foods Market and Wild Oats continued to market themselves as a healthy-foods store, each faced ever-growing competition from "conventional" supermarkets in the sale of natural, organic, fresh, healthy products, and that competition was projected to intensify as supermarkets continued to modify their formats to capture ever larger volumes of this growing segment.

Defendants contended that the FTC's proposed product market failed because it was simply counterfactual. Defendants argued that the great weight of the evidence, including company documents, market studies, econometric evidence, the views of third parties, and the testimony of the only industry expert in the case, overwhelmingly established significant, meaningful, intense and intensifying, effective competition between Whole Foods Market and a broad range of other supermarkets.

Whole Foods Market's senior operating managers, including its two co-presidents, and the regional presidents, provided critical evidence that supported a broader product market than that proposed by the FTC. Each Whole Foods Market and Wild Oats witness declaration cited to dozens of ordinary course of business documents to support the statements each made. In total, defendants incorporated about 70% of the 770 documentary exhibits into 14 party sworn statements. In this way, the declarations provided vivid, first-hand accounts of the actual competition Whole Foods Market faced every day, describing why Whole Foods Market monitored the prices of, and adjusted its prices in responses to, supermarkets such as Kroger or Safeway or Stop 'n Shop.[7] And while Whole Foods Market did compete with Wild Oats, defendants contended that it was not uniquely close competition as characterized by the FTC. The evidence showed that the prices of Wild Oats were typically higher than those of Whole Foods Market, that Whole

[7] While at first blush it may have appeared that the district court agreed with the FTC's argument that the parties' sworn statements were self-serving statements entitled to little weight, a careful reading of the court's opinion shows that the parties' strategy resonated with the court. The court agreed with the FTC only to the extent that they were in conflict with contemporaneous business documents. See FTC v. Whole Foods Market, Inc., 502 F. Supp. 2d 1 (D.D.C. 2007), at 4, n. 4. Since the declarations drew on contemporaneous documents, however, defendants argued that there were no conflicts. The decision, therefore, drew heavily on these sworn declarations and the company documents on which they were based, as Judge Friedman cited extensively to the defendants' declarations on key issues throughout the opinion.

Foods Market had developed no practices, policies, or strategies directed specifically at Wild Oats, and that Whole Foods Market did not view Wild Oats as a competitive constraint.

In addition to sworn testimony from company officials, Whole Foods Market and Wild Oats offered testimony from an industry expert, Dr. John Stanton, and two sworn statements from third party manufacturers to drive home three main points about the industry. First, these witnesses stated that Whole Foods Market possesses all of the attributes of a supermarket. It offers the same range and depth of product offerings as other supermarkets. Its focus on natural, organic, fresh, and gourmet foods merely serves as its point of differentiation. Second, the witnesses supported the proposition that differentiation is not the basis for defining the relevant product as the FTC had alleged; it is the means by which supermarkets compete with each other. The evidence showed that supermarkets differentiate themselves from one another to encourage a consumer to drive past the closest supermarket if it is not theirs. Finally, defendants presented abundant evidence that the growth in consumer demand for natural, organic, and fresh foods that had been sweeping across the country over the past five years had received considerable attention from food retailers. Supermarkets were investing significantly to adapt by changing formats and adding natural, organic, fresh, and gourmet foods, which eroded the "uniqueness" that previously served as Whole Foods Market's primary point of differentiation. The evidence showed that those investments were ongoing.

While the FTC tried to rebut these points, Defendants argued that it offered no evidence from manufacturers to suggest a unique product market of premium natural and organic supermarkets. Although there was some evidence from other food retailers, defendants contended that it all confirmed the existence of vigorous competition between those retailers and Whole Foods Market. And most importantly, the FTC elected not to cross-examine Dr. Stanton on his analysis of industry trends in response to changes in consumer demand, and offered no industry expert of its own.

The FTC's specific response to Dr. Stanton was that his views should be discounted because they were not informed by ordinary course of business documents from the defendants or third parties. But the court disagreed, noting that the "state of the industry itself is an important factor in a case like this," and that the FTC's failure to offer its own expert or to cross-examine Dr. Stanton at trial was a strategic choice made by the FTC.[8]

The parties presented economic evidence from two-time FTC Bureau of Economics Director, Dr. David Scheffman. In expert reports, depositions, and live testimony, Dr. Scheffman offered three main opinions, the first two of which addressed the FTC's alleged product market while the last addressed whether the transaction would produce anticompetitive effects. First, Dr. Scheffman conducted a critical loss analysis examining the likely response by consumers if the prices of groceries in PNOS rose relative to the prices of groceries in other supermarkets.[9]

Using either a 1% or 5% hypothetical price increase, Dr. Scheffman determined that the

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[8] Id. at 13. Dr. Stanton's report is cited fifty-five times in Judge Friedman's opinion.

[9] Critical loss analysis attempts to determine the percentage of lost sales at which a hypothetical price increase is unprofitable. The break-even point is called the critical loss. The analysis is conducted by comparing the magnitudes of actual loss, which is estimated lost volume at the hypothetical price increase, and critical loss. If the actual loss is less than critical loss, the price increase is profitable. Otherwise, it is not.

actual loss would exceed critical loss.[10] This means a projected price increase would not be profitable. Dr. Scheffman determined that the actual loss would be high because a large number of customers representing a substantial volume of purchases are marginal. And he testified that it is these marginal consumers, rather than core consumers, for which firms compete because they are susceptible to be won or retained through better prices, improved service, higher quality or more diverse product selection.

Second, Dr. Scheffman analyzed the source of sales for new Whole Foods Market stores and found that its sales were generated overwhelmingly from other supermarkets regardless of the existence of a nearby PNOS. Under the FTC's theory of the market, in areas with Wild Oats (or another PNOS), Whole Foods Market's sales should have been taken predominantly from Wild Oats. As analyzed by Dr. Scheffman, however, the data showed that Whole Foods Market sales came predominantly from other supermarkets. He also testified that in areas without PNOS, all of Whole Foods Market new store sales came from other grocery retailers, which the FTC contended were not competitors in the relevant market. Dr. Scheffman concluded that these data, which showed that the main competitive interaction was between Whole Foods Market and other grocery retailers, cannot be reconciled with the FTC's views that competition was primarily confined to PNOS.

Finally, Dr. Scheffman analyzed Whole Foods Market and Wild Oats prices. His cross-sectional pricing analysis, which examined actual prices (i.e., the prices that are loaded into the cash registers at each store), found no variation in Whole Foods Market or Wild Oats pricing based on the presence or absence of the other, an empirical observation that was inconsistent with the FTC's theory of the relevant market but, as was later pointed out by the court, consistent with the other credible evidence in the case.

"Pitching to the FTC's Heavy Hitters"

Every great player is fiercely competitive. Ty Cobb, arguably the greatest hitter in baseball behind Babe Ruth, was known for his hatred for his opponents. In this respect, Whole Foods Market CEO John Mackey is no different.

Mr. Mackey whole-heartedly believes in Whole Foods Market, its business model, and its people. He is literal and outspoken, and does not like his competitors. While the FTC heavily relied on statements of Mr. Mackey concerning Wild Oats, defendants pointed out to the court that in deposition testimony and documents, Mr. Mackey used similar tough talk to describe the full range of his competitors, including supermarkets that the FTC did not regard as part of the market in which Whole Foods Market competed.

As defendants showed, Mr. Mackey repeatedly testified and wrote about competition with many supermarkets and other food retailers as the new competitive reality for Whole Foods Market. He testified that, while Whole Foods Market may have once flown under the radar

[10] Since there was no evidence to determine the cross-elasticity of demand between PNOS and other supermarkets, Dr. Scheffman based his estimate of actual loss on, among other things, information and data contained in forty-seven market studies, which revealed that grocery shopping is highly price sensitive, the absence of a large, definable core group among PNOS consumers, that consumers can and do shift purchases between PNOS and other supermarkets, that most Whole Foods Market and Wild Oats consumers also shop at other supermarkets, and that other supermarkets actively target Whole Foods Market and Wild Oats consumers.

of larger supermarkets, as its business grew its threat to these supermarkets grew as well. Larger supermarkets noticed Whole Foods Market's growth and mimicked its ingredients for success. Mr. Mackey stated on many occasions that Whole Foods Market has never faced more competition than it does today. Defendants argued that, taken as a whole, the full record of Mr. Mackey's statements proved that he is intensely competitive and keenly aware of the threats facing his company from competitors across the spectrum of food retailing, and not just Wild Oats.[11]

Defendants' attack on Dr. Murphy, the FTC's expert, was more difficult because of his solid credentials and the mountain of econometric analyses on which he relied. The FTC depended on three lines of Dr. Murphy's analysis to support its position about both market definition and the transaction's likely competitive effects: (1) his analysis of the effect of Whole Foods Market's entry on Wild Oats' margins; (2) his cross-sectional analysis of margin data to show that margins at Whole Foods Market's stores varied based on the presence or absence of Wild Oats; and (3) his study of the effect of Whole Foods Market entry on Wild Oats' prices.

Through cross examination, defendants sought to show that Dr. Murphy studied the wrong events and used the wrong measures. Specifically, defendants tried to establish, and believe they did establish, that Dr. Murphy's use of margin data rather than prices was fraught with problems because of the inability to control for mix or "partial shrinkage." The margin on a shopping basket can vary with the product mix, and the failure to account for mix can undermine the reliability of the analysis. "Partial shrinkage" can occur when merchandise is marked down for quick sale. Neither of the defendants tracked "partial shrinkage." Dr. Murphy's economic models did not consider "partial shrinkage," which can be most pronounced in periods of competitive entry. Defendants contended that these deficiencies rendered any conclusions from these analyses suspect. Dr. Murphy offered no direct evidence that Wild Oats imposed a unique price constraint on Whole Foods Market. The evidence revealed that Wild Oats' prices were, in fact, higher than Whole Foods Market's prices. Dr. Murphy attempted to use margins to show that Whole Foods Market margins varied across stores depending on the presence of a Wild Oats store nearby, and made inferences about price from these results. But Dr. Murphy testified on cross examination that his analysis produced a result that was not statistically significantly different from zero. Defendants thus argued that Dr. Murphy's cross-sectional analysis showed that Whole Foods Market's margins were not dependent on the presence or absence of Wild Oats.

Dr. Murphy also sought to draw inferences about the effects of potential Wild Oats store closings on Whole Foods Market's prices by studying the effect Whole Foods Market's entry had on Wild Oats' prices and margins. Dr. Murphy testified that one could predict the effect on Whole Foods Market's prices of closing Wild Oats stores from the effects Whole Foods Market had on Wild Oats. In essence, Dr. Murphy asked the court to accept that the exit of a high-priced firm (Wild Oats) would have the same effect as the entry of a lower-priced, higher quality firm (Whole Foods Market). The court disagreed, noting that it was "unwilling to accept the assumption that the effects on Wild Oats from Whole Foods Market's entries provide a mirror from which predictions can reliably be made about

[11] It was, therefore, only mildly surprising to find no reference to John Mackey's statements in the district court opinion. In context, Mackey's statements were consistent with the view that Whole Foods Market competes with many supermarkets, one of which was Wild Oats.

the effects on Whole Foods Market from Wild Oats' future exits if this transaction occurs."[12]

Finally, Dr. Murphy examined the effect of Whole Foods Market entry on Wild Oats prices. Although Dr. Murphy selected five entry events to study, he relied on the results from only two–West Hartford, CT[13] and Fort Collins, CO. From these two events, Dr. Murphy concluded that Wild Oats' prices are lower following Whole Foods Market entry. Defendants contended that the study was flawed, however, for three main reasons. First, a finding that Wild Oats prices are lower after Whole Foods Market entered West Hartford, CT was not a good predictor about whether Whole Foods Market would raise prices in West Hartford, CT or anywhere else. Second, Dr. Murphy's analysis failed to control for entry by other firms. In Fort Collins, CO, for example, King Soopers, a supermarket owned by Kroger, entered within five miles of Wild Oats at essentially the same time as Whole Foods Market entered. But Dr. Murphy attributed the entire price effect to Whole Foods Market's entry. Third, Wild Oats, in fact, exited Fort Collins, and yet Dr. Murphy did not study Whole Foods Market's prices in Fort Collins after Wild Oats' exit.

[12] FTC v. Whole Foods Market, Inc., 502 F. Supp. 2d at 21.

[13] Dr. Murphy's findings in West Hartford, CT, however, were skewed because of the relative prices of each firm's salad bars. Removing the salad bars from the pricing study essentially muted the pricing disparity.

"A Post-Game Comment on the FTC's Lineup Against Whole Foods Market vs. Its Lineup Against Staples, Inc."

In FTC v. Staples, Inc., the FTC successfully proved a novel, narrow product market–namely, the sale of consumable office supplies through office superstores.[14] Staples also provided a blueprint for analyzing horizontal retail mergers. The differences between the evidence the FTC offered in Staples compared to that offered by the FTC in Whole Foods Market is striking, and may explain the different results.

- Declarations. In Staples, the FTC had 36 third party declarations while in the Whole Foods Market case, it had only one–a statement from a food retailer that was not even a supermarket.

- Documents and entry analyses. In Staples, the defendants' documents, including analysis of new market entry, showed that they focused primarily on competition from other superstores. The defendants' documents in Whole Foods Market, including new market entry analyses, focused primarily on other supermarkets, not PNOS.

- Pricing vs. margin data. In Staples, the FTC focused on pricing evidence while the FTC focused on margin evidence in Whole Foods Market.

[14] 970 F. Supp. 1066 (D.D.C. 1997).

- Price effects. The FTC showed that Staples priced 13% higher in one-firm markets than in three-firm markets. But neither Whole Foods Market nor Wild Oats prices were different in one-firm markets as compared to markets in which other PNOS existed.

- Constraining effect of the acquired firm. In Staples, the defendants were deep discounters, and the acquired firm was an aggressive competitor which helped drive prices lower. Wild Oats, on the other hand, was a higher priced competitor, far from aggressive, and had no effect on Whole Foods Market pricing.

While we believe the district court reached the correct decision, and that the D.C. Circuit properly denied the FTC's emergency motion for a stay pending appeal, this litigation was every bit a battle between two deep teams, both championing different but vital principles of competition and both committed to diametrically opposed views about the marketplace facts. And while it is not clear whether the FTC's challenge to Whole Foods Market is truly analogous to big-league baseball, it was, without question, an interesting way to spend the summer.