FTC v. Whole Foods: FTC Scores Premium Victory in D.C. Circuit

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The Federal Trade Commission (FTC) won a major victory last week when a splintered D.C. Circuit overturned the district court's denial of its request for a preliminary injunction against the acquisition of Wild Oats by Whole Foods.[1] The decision provides the FTC a much-needed win in a prominent merger case. It also reaffirms both the centrality of detailed, case-specific facts and economic analysis to the antitrust analysis of mergers and the limited role for the courts in sifting through competing plausible and factually-supported theories and conclusions in preliminary injunction actions brought by the FTC. In addition, *Whole Foods* shows once again the damage that parties can do to their case by creating "hot documents" suggesting that their transaction may harm competition.

Background

In June 2007, the FTC issued an administrative complaint alleging that the proposed purchase of Wild Oats by another grocery retailer, Whole Foods, would violate Section 7 of the Clayton Act. At the same time, the Commission petitioned the district court for a preliminary injunction, under Section 13(b) of the FTC Act (15 U.S.C. § 53(b)), to prohibit the parties from closing the transaction pending completion of FTC administrative proceedings to determine whether to block the transaction permanently. The FTC alleged that Whole Foods and Wild Oats were the first and second largest chains in a market consisting of "premium, natural and organic supermarkets" (PNOS), and that the transaction would create a monopoly in such a market in 18 cities. The Commission relied principally on expert economist testimony and "hot documents" from Whole Foods's files (including well-publicized statements from its CEO) suggesting that Whole Foods and Wild Oats were the only two national supermarket chains of their type, and that the purpose of the merger was to eliminate Whole Foods' most significant competitor.

In opposing a preliminary injunction, the merging parties attacked the FTC's contention that there is a distinct market of "premium, natural organic supermarkets," and argued that Whole Foods and Wild Oats in fact compete in a broader market of grocery stores and supermarkets. The merging parties relied primarily on their own economic expert testimony; third party studies; internal documents showing that Whole Foods and Wild Oats monitored many supermarkets' prices, not

just each other's; and testimony from other supermarket executives that believed they competed with Whole Foods and Wild Oats.

After accelerated proceedings and a two-day hearing, the district court denied the FTC's request for a preliminary injunction. The court held that the FTC's case turned on whether the relevant market was limited to PNOS, but the evidence showed that the market was larger and included ordinary grocery stores and supermarkets. Because it concluded the FTC had no chance of success on the merits, the district court denied a preliminary injunction without considering any other factors.

The FTC unsuccessfully petitioned the D.C. Circuit for an injunction pending appeal. Free from any legal restraints on closing, Whole Foods acquired Wild Oats, and in the 11 months that followed, closed some of the acquired stores and sold other stores and related assets. The FTC, meanwhile, continued to pursue its appeal in the D.C. Circuit.

D.C. Circuit Decision

In a two-to-one decision, the D.C. Circuit reversed the district court, with each judge writing separately. Notably, the decision does not automatically give the FTC the injunction it wanted; instead, the court remanded to the district court to weigh the equities and determine whether an injunction would be in the public interest. The three opinions each had different takes on the issues central to the case, and warrant separate discussion.

Judge Brown's Opinion for the Court

Judge Brown, writing for the court, first rejected Whole Foods's argument that the FTC's request for an injunction was moot because the deal had already closed and the parties had taken actions that scrambled the eggs. Slip Op. at 5-7. She pointed out that, if it were ultimately to find the acquisition unlawful after its administrative proceeding, the FTC would have available a broad range of possible remedies to restore competition--including ordering a divestiture and possibly additional relief. *Id.* at 5. It will be for the district court to determine whether preliminary relief to maintain the status quo--such as issuing a hold separate order or possibly even ordering the parties to restore the pre-merger status quo--would make it more feasible for the FTC to impose meaningful relief after any finding of illegality. *Id*. at 6.

The court next turned to the standard for an injunction under Section 13(b), which authorizes a district court to grant preliminary relief--pending an FTC administrative proceeding--"[u]pon a proper showing that, weighing the equities and considering the Commission's likelihood of success, such action would be in the public interest." 15 U.S.C. § 53(b). Congress adopted this special standard because it "recognized the traditional four-part equity standard for obtaining an injunction was not appropriate for the implementation of a Federal statute by an independent regulatory agency." Accordingly, unlike with the traditional injunction standard, "the FTC need not show any irreparable harm, and the 'private equities' alone cannot override the FTC's showing of likelihood of success." *Id*. at 7-8.

Under Section 13(b), "the FTC will usually be able to obtain a preliminary injunction blocking a merger by 'rais[ing] questions going to the merits so serious, substantial, difficult[,] and doubtful as

to make them grounds for thorough investigation.'" *Id.* at 8. (quoting *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 714-15 (D.C. Cir. 2001)). By meeting this standard, the FTC creates a presumption in favor of a preliminary injunction. *Id.* But the court must still apply a "sliding scale." *Id.* If the parties show "equities weighing in favor of the merger," the FTC will be required "to demonstrate a greater likelihood of success"; conversely, "a greater likelihood of the FTC's success will militate for a preliminary injunction unless particularly strong equities favor the merging parties." *Id.* "In any case, a district court must not require the FTC to prove the merits because, in a [Section 13(b)] preliminary injunction proceeding, a court is not authorized to determine whether the antitrust laws are about to be violated. That responsibility lies with the FTC." *Id.* (internal quotations and citation omitted). But the court may not "simply rubber-stamp an injunction whenever the FTC provides some threshold evidence; it must exercise independent judgment about the questions [Section 13(b)] commits to it." *Id.* (internal quotations omitted).

The court went on to hold that the district court erred in failing to apply the sliding scale and declining to consider the equities, which "rested on a conviction the FTC entirely failed to show a likelihood of success." In particular, the district court committed a legal error in rejecting the FTC's proffered PNOS product market definition by focusing only on marginal consumers and "ignor[ing] FTC evidence that strongly suggested Whole Foods and Wild Oats compete for core customers within a PNOS market, even if they also compete on individual products for marginal customers in the broader market." *Id.* at 13. The court focused on FTC evidence that "delineated a PNOS submarket catering to a core group of customers who have decided that natural and organic is important, lifestyle of health and ecological sustainability is important," and that the merged Whole Foods/Wild Oats could use what the court called "price discrimination" to "profit from core customers for whom it is the sole supplier." *Id.* at 17. (The FTC had pointed to evidence that over two-thirds of Whole Foods customers were "core customers." *Id.* at 18-19.)

Notably, the court did not describe price discrimination in the sense of a firm pricing the *same product* differently to *different customers* based on their differing demand curves; rather, it pointed to FTC evidence that the merger could lessen competition for "perishables," which account for 70% of Whole Foods's business, even though it might not affect competition for "dry grocery" products (where the merging parties compete with conventional supermarkets). *Id.* at 17-18. It cited in particular:

- Economic evidence that Whole Foods's margins were significantly lower (on perishables, though not groceries) in cities where Whole Foods and Wild Oats compete (*id.*);
- Whole Foods documents showing that when it price checked against conventional supermarkets, it focused overwhelmingly on dry groceries rather than perishables (*id.* at 18);
- Evidence that the opening of a Whole Foods in the vicinity of a Wild Oats caused Wild Oats's prices to drop, and the opening of conventional supermarkets did not (*id.*); and
- Whole Foods's internal projections suggesting that "if a Wild Oats near a Whole Foods were to close, the majority (in some cases nearly all) of its customers would switch to the Whole Foods rather than to conventional supermarkets" (*id.*).

The court concluded that "we cannot agree with the district court that the FTC would never be able to prove a PNOS submarket," although "[w]e do not say the FTC has in fact proved such a market, which is not necessary at this point." *Id.* at 20. Rather than address the equities to "see whether for some reason there is a balance against the FTC that would require a greater likelihood of success," the court remanded to the district court to perform that task. *Id.* The court cautioned that "[a]lthough the equities in a [Section 13(b)] preliminary injunction proceeding will usually favor the FTC . . . the district court must independently exercise its discretion considering the circumstances of this case, including the fact that the merger has taken place."

Judge Tatel's Concurrence

In his concurrence, Judge Tatel agreed with Judge Brown that "the district court erred in focusing only on marginal customers," Concurring Op. at 1, but emphasized his view that the district court had improperly rejected additional evidence that Whole Foods and Wild Oats occupy a separate PNOS market. *Id.* Judge Tatel described in some detail several pieces of FTC evidence, but his focus on certain hot documents from the companies' files is of particular interest:

- Whole Foods had prepared a study--called "Project Goldmine"--showing that, in cities where Whole Foods planned to close Wild Oats stores, "the average Whole Foods store would capture most of the revenue from the closed Wild Oats store, even though virtually every city contained multiple conventional retailers closer to the shuttered Wild Oats store." *Id.* at 5.
- Whole Foods's CEO wrote an email to the company's board explaining that "[Wild Oats] is the one existing company that has the brand and number of stores to be a meaningful springboard for another player to get into this space. Eliminating them means eliminating this threat forever, or almost forever." *Id.* at 7.
- In another documents, the CEO explained that the transaction made sense because "by buying [Wild Oats] we will ... avoid nasty price wars in [several cities where both companies have stores]." *Id.* at 11.

Judge Tatel observed that, although the dissent contended that the CEO's statements were irrelevant because intent is not an element of a Section 7 claim, the Supreme Court has stated that "evidence indicating the purpose of the merging parties . . . *is an aid* in predicting the probable future conduct of the parties and thus the probable effects of the merger." *Id.* at 12 (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 329 n. 48 (1962).

Judge Tatel took special care to emphasize the distinction between the level of proof necessary for the FTC to obtain an injunction under Section 13(b) and the level of proof necessary for the FTC to prove its case in an administrative proceeding: "Whole Foods has a great deal of evidence on its side, evidence that may ultimately convince the Commission that no separate market exists. But at this preliminary stage, the FTC's evidence plainly establishes a reasonable probability that it will be able to prove its asserted market." *Id.* at 16. Accordingly, the FTC had demonstrated the "requisite likelihood of success by raising serious and substantial questions about the merger's legality," and it remained for the district court to weigh the equities to decide whether to issue a preliminary

injunction. *Id.*

Judge Kavanaugh's Dissent

Writing in dissent, Judge Kavanaugh, first argued that the other judges had taken an overly narrow view of the role of the district court in weighing competing evidence going to the merits. He wrote, "[w]ith all due respect, I do not believe that the law allows the FTC to just snap its fingers and block a merger. . . . And even at the preliminary injunction stage our precedents expressly require that the FTC show a likelihood of success on the merits. . . The FTC needs to come forward with some solid evidence that the post-merger company could profitably impose a 'small but significant and nontransitory increase in price.'" Dissenting Op. at 3 (internal quotation and citations omitted). Judge Kavanaugh further asserted that "[m]y colleagues, and especially the concurrence, hint that the FTC need not demonstrate a likelihood of success to obtain a preliminary objection" and that such a reading of Section 13 would "enhance the FTC's powers to torpedo mergers well beyond what Congress had authorized." *Id.* at 3 n.3.

Judge Kavanaugh characterized the matter as "a straightforward case" and emphasized his view that the FTC had committed a "basic antitrust mistake" by confusing product differentiation in competition for supermarket patronage with separate product markets. *Id.* at 2-4. In his view, the FTC's pricing evidence overwhelmingly showed that, though Whole Foods and Wild Oats differentiate themselves by emphasizing organic and premium products, they compete in an overall supermarket market with other stores that differentiate themselves in other ways. *Id.* at 11. He found "all-but-dispositive" studies submitted by Whole Foods's economic expert purporting to show that Whole Foods and Wild Oats do not price higher when they face competition from each other or other premium, natural and organic supermarkets,[2] and that Whole Foods has not raised its prices when a nearby Wild Oats left the market. *Id.* at 6-8.

After critiquing several of the FTC's arguments, Judge Kavanaugh concluded by sharply criticizing the majority's focus on marginal versus core consumers as "elid[ing]" the question of whether the merger would lead to a sustained price increase:

> "Sure, there may be consumers who are so wedded to Whole Foods that they'll pay much higher prices. But are there enough such that Whole Foods can profitably impose a significant and nontransitory price increase? That's the question, and as explained above and found by the District Court, the record convincingly demonstrates that the answer is no."

Id. at 17.

Implications of *Whole Foods*

We may well not have seen the last of *Whole Foods*. Particularly given the sharp divisions among the panel, Whole Foods may well petition for en banc review. And it remains to be seen whether and how the FTC will proceed, given that the deal has been closed for so long. Nevertheless, the panel decision reinforces some important points for parties contemplating a merger that may become contentious.

First, in FTC merger challenges, at least the D.C. Circuit takes quite seriously that Section 13(b) provides a special standard for considering an injunction pending FTC administrative review.[3]

Accordingly, though the court has made clear that district courts must hold the FTC to its burden of showing proof that establishes a serious question going to the merits, it has also made clear that it is not the district court's role to choose between competing plausible and factually-supported theories offered by the FTC and the parties seeking to merge. Merging parties considering whether to litigate with the FTC--particularly when jurisdiction can lie in the District of Columbia--need to recognize that they may find themselves enjoined from closing their transaction pending lengthy administrative proceedings, even if they might be able ultimately to prevail on the substantive merits.

Second, *Whole Foods* is a powerful reminder of the importance of not creating bad documents suggesting that a transaction may lessen competition. Though such statements may--and often will--evidence hyperbole rather than objective probability, courts and the agencies may view the documents as reflecting considered predictions about likely competitive effects--from those in the best position to know. Not only can bad documents lead to a merger investigation in the first place or extend an investigation that would otherwise have been routine, they can have devastating consequences in a litigated deal, particularly when, as here, they are created by a very senior officer or the board of directors.

Third, in evaluating mergers, the courts and agencies will focus on the likely competitive effects for core--or inframarginal--customers, not just marginal customers. Even when there are close substitute suppliers for many consumers, the courts and agencies will ask in the first instance whether there are sufficient marginal customers to constrain price increases or quality decreases. Moreover, even if the deal will not lead to generalized price increases, they will examine whether the merged firm will be able successfully to price discriminate against core customers. In addition, as *Whole Foods* shows, in a retail merger, the courts and agencies may examine whether the transaction will lessen competition for a subset of products in the store, even if it will not lead to across-the-board price increases or quality decreases.

[1] A copy of the decision, *Federal Trade Commission v. Whole Foods Market*, D.C. Cir. No. 07-5276, is available here.

[2] Judge Tatel criticized this study as "all-but-meaningless price evidence" because it examined Whole Foods prices on a single day several months after Whole Foods announced its intent to acquire Wild Oats. Concurring Op. at 11. In Judge Tatel's view, "this gave the company every incentive to eliminate any price differences that may have previously existed between its stores based on the presence of a nearby Wild Oats, not only to avoid antitrust liability, but also because the company was no longer competing with Wild Oats." *Id.* Judge Kavanaugh responded that Judge Tatel had offered no evidence for his assertion that Whole Foods manipulated its prices to support its expert study. Dissenting Op. at 8 n.4.

[3] This is not new. The D.C. Circuit has previously stated that the standard under 13(b) is different than that under the Rules of Civil Procedure. *See FTC v. H.J. Heinz Co.*, 246 F.3d 708, 714-15 (D.C. Cir. 2001).

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