FEDERAL COURT REJECTS FTC REQUEST TO BLOCK WHOLE FOODS — WILD OATS SUPERMARKET MERGER

On August 16, 2007, the United States District Court for the District of Columbia denied the request of the Federal Trade Commission ("FTC") for a preliminary injunction to block the acquisition of Wild Oats Markets, Inc. by Whole Foods Market, Inc. Judge Paul Friedman's detailed, 93-page opinion rejected the FTC's fundamental argument against the merger: That it would lead to a virtual monopoly in a market for "premium natural and organic supermarkets" ("PNOS") across the United States. The United States Court of Appeals for the District of Columbia Circuit denied the FTC's motion for an injunction staying the transaction pending the FTC's appeal, and the parties consummated the merger on August 27, 2007.

Whole Foods is the largest operator of PNOS in the United States, having 194 stores. Wild Oats was the second largest PNOS operator in the United States, with 115 stores that were generally smaller in size and higher in price than Whole Foods stores. Both firms concentrated on selling natural and organic food items and emphasizing customer service, but both also carried a variety of non-natural foods items.

As is often true in merger analysis, the pivotal question was how to define the relevant market affected by the merger. As Judge Friedman summarized the issue:

> In this case, if the relevant product market is, as the FTC alleges, a product market of 'premium natural and organic supermarkets' consisting only of the two defendants and two other non-national firms, there can be little doubt that the acquisition of the second largest firm in the market by the largest firm in the market will tend to harm competition in that market. If, on the other hand, the defendants are merely differentiated firms operating within the larger relevant product market of 'supermarkets,' the proposed merger will not tend to harm competition.

Opinion at 9-10. To address that issue, the parties presented voluminous documentary evidence, deposition transcripts, affidavits, and the live testimony of two prominent economists. Notably, in his evaluation, Judge Friedman credited objective marketplace evidence and ordinary-course business documents more than Whole Foods' statements that, according to the FTC, described the rationale for the transaction as eliminating competition with Wild Oats.

Judge Friedman ruled that the competitive effects of the transaction should be evaluated by reference to whether the merger would allow the combined firm profitably to raise prices. He agreed with defendants' economist, Dr. David Scheffman, that the answer to that question should be found by analyzing whether a "small but significant and non-transitory price increase" ("SSNIP") could be imposed by the combined firm without losing so many customers as to make that price increase unprofitable. Opinion at 30. He further ruled that the analytical focus should be on those customers most likely to consider competitive alternatives ("marginal customers") rather than on the "core" customers who might be assumed to be willing to pay a higher price. Opinion at 38.

With that analytical framework in mind, Judge Friedman accepted Dr. Scheffman's conclusion that, under either the five-percent SSNIP test commonly used under the government's Merger Guidelines[1] or under a more stringent one-percent SSNIP test, the combined firm would lose enough marginal customers to other non-PNOS entities to make such a price increase unprofitable. That led to the conclusion that those other supermarkets had to be considered part of the relevant product market. In that broader market, the merger would not likely harm competition. Opinion at 31.

Dr. Scheffman's conclusion that either a five-percent SSNIP or a one-percent SSNIP would produce a "critical loss" for the combined firm was based on his assessment of market studies, from which he drew the following factual inferences: (1) groceries are a highly price-sensitive category of retail goods, (2) customers of the merging firms shifted their purchases between PNOS and other supermarkets and can further shift purchases without having to change their shopping patterns, (3) most customers of the merging firms shop frequently at other grocery stores, (4) other supermarkets compete vigorously for the patronage of customers that also shop at the merging firms, and (5) each of the merging firms price-checked non-PNOS stores to gauge its pricing and product strategies. Opinion at 29-30. Dr. Scheffman also observed that, when a new Whole Foods store opened in a geographic area already served by a Wild Oats store, the new store's sales came predominantly from traditional or conventional supermarkets, not from Wild Oats. Opinion at 32.

The FTC's economist, Dr. Kevin Murphy, focused on instances in which new Whole Foods stores entered into areas served by an existing Wild Oats store. Dr. Murphy concluded that the entry of a Whole Foods store had a greater effect on Wild Oats than the introduction of competition from other new supermarkets. From those data, Dr. Murphy concluded that similar effects would occur from the exit of Wild Oats as a competitor following the merger. Judge Friedman rejected that conclusion:

> The Court is unwilling to accept the assumption that the effects on Wild Oats from Whole Foods' entries provide a mirror from which predictions can reliably be made about the effects on Whole Foods from Wild Oats' future exits if this transaction occurs.

Opinion at 35.

Significantly, the FTC identified no evidence that either of Whole Foods or Wild Oats imposed a particular or unique competitive constraint on the other. Rather, Judge Friedman found that Wild Oats' prices were generally higher than those of Whole Foods in the areas in which they competed, that Whole Foods' prices did not vary depending on the presence or absence of Wild Oats, and that Whole Foods "competes vigorously with other supermarkets to retain the business of its many marginal customers." Opinion at 36.

Judge Friedman also accepted the conclusions of Dr. John Stanton, a grocery marketing expert who testified for the merging firms. Dr. Stanton testified that the differences between PNOS and other supermarkets were indicative of product differentiation resulting from the supermarket firms'

---

1 Department of Justice & Federal Trade Commission, *Horizontal Merger Guidelines* § 1.11 (1997).

efforts to compete with one another. Judge Friedman quoted with approval the following passage from Dr. Stanton's expert report, which concluded importantly that product differentiation is a means of competition, not a bar to competition or evidence of separate markets:

> Whole Foods and Wild Oats each compete in the supermarket industry with a plethora of other supermarket businesses. All supermarket retailers, including Whole Foods, attempt to differentiate themselves so as to give customers a reason to shop its stores over its competitors. *This does not, however, indicate that differentiated supermarkets do not compete with each other; to the contrary, it is how they compete with each other.* As consumer demand for fresh, healthy, organic and natural products has increased, more and more supermarket competitors have expanded their product offerings and store formats to more effectively compete for customers; the same customer base that Whole Foods is targeting.

Opinion at 56, quoting Stanton Report Par. 3 (emphasis added by the Court). Judge Friedman also provided a lengthy summary of evidence that, he concluded, showed that at least six major supermarket chains have already engaged in substantial repositioning of their product offerings to compete more directly with Whole Foods. Opinion at 74-89.

In sum, Whole Foods illustrates the importance of objective evidence and cogent expert analysis — particularly with respect to market definition — to the resolution of merger cases.

* * * * * * * * * * * * * * *

For further information regarding this memorandum or on antitrust or competition issues generally, please contact our practitioners in our U.S. or European offices: William H. Rooney (212-728-8259, wrooney@willkie.com) or David K. Park (212-728-8760, dpark@willkie.com) in our New York office, Bernard A. Nigro, Jr. (202-303-1125, bnigro@willkie.com) or Theodore C. Whitehouse (202-303-1118, twhitehouse@willkie.com) in our Washington, D.C. office, Jacques-Philippe Gunther (33-1-53-43-4538, jgunther@willkie.com) or David Tayar (33-1-53-43-4690, dtayar@willkie.com) in our Paris office, or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

September 7, 2007

Copyright © 2007 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.