Spring 2008

Four Lessons from the Whole Foods Case

Thom Lambert

University of Missouri School of Law, lambertt@missouri.edu

Follow this and additional works at: https://scholarship.law.missouri.edu/facpubs

Part of the Antitrust and Trade Regulation Commons

Recommended Citation
Available at: https://scholarship.law.missouri.edu/facpubs/863

This Article is brought to you for free and open access by the Faculty Scholarship at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Faculty Publications by an authorized administrator of University of Missouri School of Law Scholarship Repository. For more information, please contact bassettcw@missouri.edu.
Four Lessons from the Whole Foods Case

By Thomas A. Lambert
University of Missouri–Columbia School of Law

One of the most maligned antitrust decisions in history involved a merger of grocery store chains. Indeed, even those voices inclined toward substantial antitrust intervention believe the U.S. Supreme Court erred in its 1966 Von’s Grocery decision, which condemned the merger of the third- and sixth-largest grocery store chains in Los Angeles. For example, the president of the reliably interventionist American Antitrust Institute conceded that the Supreme Court “probably went too far” and acknowledged that “if Von’s Grocery had remained the rule, all of our industries would be highly fragmented and consumers would have lost out on many cost-cutting efficiencies.” The fact is, grocery retailing involves huge scale economies and low barriers to entry—a combination that renders most consolidations beneficial to consumers.

Despite the apparent consensus on Von’s Grocery, federal antitrust regulators seem determined to repeat its mistakes. Last summer, the Federal Trade Commission shocked the business community by seeking to block the merger of two high-end grocery chains, Whole Foods Markets and Wild Oats Markets. Fortunately for consumers, cooler heads prevailed—the federal court hearing the FTC’s merger challenge rejected the agency’s motion for preliminary injunction. But while things turned out all right this time, the incident reveals a number of deficiencies in the merger review process. This article describes the Whole Foods debacle and catalogues four lessons regulators and courts should draw from the incident.

The FTC’s Challenge

In February 2007, Whole Foods and Wild Oats entered an agreement under which Whole Foods would acquire Wild Oats for approximately $670 million. Four months later, after collecting 20 million documents from the two companies (but almost no pricing data), the FTC sued to block the merger. The agency claimed the merger would constitute an anticompetitive combination of the top two competitors in the highly concentrated market for “premium natural and organic supermarkets.”

According to the FTC’s complaint, such supermarkets constitute a separate market from conventional supermarkets because they “offer a distinct set of products and services to a distinct group of customers in a distinctive way.” With respect to their product offerings, premium natural and organic supermarkets are distinct in that they “focus on perishable products, offering a vast selection of very high-quality fresh fruits and vegetables—including exotic and hard-to-find items—and other perishables.” Customers of premium natural and organic supermarkets are also distinct: in the FTC’s words, they’re “affluent, well-educated, health-oriented, quality food oriented people.” Finally, the FTC asserted, premium natural and organic supermarkets provide a distinctively higher level of service: more amenities, a more knowledgeable staff, branding that promotes a healthy lifestyle and ecological sustainability, and a place for shoppers to “gather, interact, and learn.” Because of those distinguishing characteristics, the FTC maintained, premium natural and organic supermarkets, of which Whole Foods and Wild Oats are the only national chains, compete in a separate market from such conventional supermarkets as Safeway and Kroger. A merger of the two chains would virtually eliminate competition in that distinct market, thereby harming con-
sumers by causing higher prices or reduced levels of service.

Of course, a narrow market definition was crucial to the FTC's challenge. If the market in which Whole Foods and Wild Oats participate includes conventional grocers like Kroger and Safeway (or maybe even the nation's largest grocer, Wal-Mart, which now carries an extensive collection of organic products), then consolidation of the two firms would have little competitive effect; there would still be substantial competition in the market after the consolidation of the two chains into one. Thus, the FTC's challenge could go nowhere unless the market were defined to exclude conventional supermarkets and other retailers of food and groceries.

To support its narrow market definition — the lynchpin of its case — the FTC initially relied almost entirely on Whole Foods' own characterization of its market in its internal documents. For example, the FTC's complaint pointed to a statement lifted from Whole Foods' announcement of its fourth quarter 2006 earnings: "Whole Foods Market is about much more than just selling 'commodity' natural and organic products. We are a lifestyle retailer and have created a unique shopping environment built around satisfying and delighting our customers." That statement and others like it formed the primary basis for the FTC's allegation that premium natural and organic supermarkets like Whole Foods and Wild Oats constitute a distinct antitrust market.

**WRONG QUESTION** Not until it had filed its complaint and put a temporary hold on the merger did the FTC try to build an economic case for a distinct market consisting of premium natural and organic supermarkets. To do so, the agency needed evidence concerning cross-elasticities of demand — i.e., the degree to which consumers would switch to other sources of supply in response to a price increase. Under the FTC's own horizontal merger guidelines, the contours of a market are determined entirely on the basis of such elasticities. Specifically, a market is defined by lumping together the narrowest possible grouping of products or services that could constitute the market (say, a single brand of the product or service) and asking whether a hypothetical single seller of those goods or services could profitably impose a "small but significant non-transitory increase in price" — usually a 1–5 percent price increase for a one-year period. If the price increase would not be profitable because it would induce too many consumers to switch to alternatives, then the collection is expanded to include the next-best product or service, and the question is repeated. This process continues until it reveals a grouping of products or services for which a price increase would be profitable. That grouping constitutes the relevant market. In the Whole Foods/Wild Oats case, then, the key question would be whether a price increase by so-called premium natural and organic supermarkets would drive so many
consumers to conventional supermarkets that the price increase would not be profitable.

In light of this economic approach to defining markets—an approach that turns entirely on how customers respond to price changes—it is astounding that the agency collected no pricing data from Whole Foods and Wild Oats until after it had filed its complaint. It chose instead to base its market definition on statements from Whole Foods executives touting the chain’s distinctiveness. It also relied heavily on a troubling e-mail that Whole Foods CEO John Mackey sent to the board of directors to drum up support for the Wild Oats merger:

By buying [Wild Oats] we will...avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm [Whole Foods'] gross margins and profitability. By buying [Wild Oats]...we eliminate forever the possibility of Kroger, Super Value, or Safeway using their brand equity to increase would not be profitable.

As it turns out, both Whole Foods’ self-promoting market characterizations (intended to tout its business model) and Mackey’s claims about how the merger would reduce price competition (intended to persuade board members to support the merger) were wrong. When the FTC finally got around to collecting and analyzing pricing data, it could show neither that premium natural and organic supermarkets constitute a market separate from conventional supermarkets nor that a combined Whole Foods/Wild Oats would be able to avoid price competition. Faced with the real world pricing data, the most the agency’s expert economist, University of Chicago professor Kevin Murphy, could conclude on the market definition question was that (1) Whole Foods and Wild Oats are close substitutes for one another, (2) there is significant competition between the two supermarkets, and (3) Whole Foods had a disciplining effect on Wild Oats’ prices.

That was not enough. No one ever doubted the first two conclusions, which are wholly irrelevant to the question of whether conventional grocers and other food sellers also compete with Whole Foods and Wild Oats. The third conclusion answers the wrong question: because the plan called for the merged firm to close Wild Oats stores after the merger, the relevant question would be whether Wild Oats stores (the ones to be eliminated) had a disciplining effect on Whole Foods’ pricing—not vice-versa. Murphy conceded that the data could not establish either that exit of a Wild Oats store led to higher prices at a neighboring Whole Foods or that entry of a Wild Oats store reduced prices at a nearby Whole Foods. Nor could the data show anything about how the entry or exit of conventional supermarkets affected Whole Foods’ pricing. (There are so many conventional supermarkets that it was impossible to find a geographic region where either a first conventional supermarket moved into a Whole Foods neighborhood or a last conventional supermarket moved out of the neighborhood.)

On the question of whether conventional supermarkets would respond to price increases at Whole Foods by expanding natural and organic offerings and enhancing services, Murphy could say almost nothing of substance. The fact is, con-

### The merger of two relatively small players would not give the combined firm the power to raise prices and/or cut back on services.

launch a competing natural organic food chain to rival us....[Wild Oats] may not be able to defeat us but they can still hurt us.... [Wild Oats] is the only 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.

As it turns out, both Whole Foods’ self-promoting market characterizations (intended to tout its business model) and Mackey’s claims about how the merger would reduce price competition (intended to persuade board members to support the merger) were wrong. When the FTC finally got around to collecting and analyzing pricing data, it could show neither that premium natural and organic supermarkets constitute a market separate from conventional supermarkets nor that a combined Whole Foods/Wild Oats would be able to avoid price competition. Faced with the real world pricing data, the most the agency’s expert economist, University of Chicago professor Kevin Murphy, could conclude on the market definition question was that (1) Whole Foods and Wild Oats are close substitutes for one another, (2) there is significant competition between the two supermarkets, and (3) Whole Foods had a disciplining effect on Wild Oats’ prices.

That was not enough. No one ever doubted the first two conclusions, which are wholly irrelevant to the question of whether conventional grocers and other food sellers also compete with Whole Foods and Wild Oats. The third conclusion answers the wrong question: because the plan called for the merged firm to close Wild Oats stores after the merger, the relevant question would be whether Wild Oats stores (the ones to be eliminated) had a disciplining effect on Whole Foods’ pricing—not vice-versa. Murphy conceded that the data could not establish either that exit of a Wild Oats store led to higher prices at a neighboring Whole Foods or that entry of a Wild Oats store reduced prices at a nearby Whole Foods. Nor could the data show anything about how the entry or exit of conventional supermarkets affected Whole Foods’ pricing. (There are so many conventional supermarkets that it was impossible to find a geographic region where either a first conventional supermarket moved into a Whole Foods neighborhood or a last conventional supermarket moved out of the neighborhood.)

On the question of whether conventional supermarkets would respond to price increases at Whole Foods by expanding natural and organic offerings and enhancing services, Murphy could say almost nothing of substance. The fact is, con-

### The merger of two relatively small players would not give the combined firm the power to raise prices and/or cut back on services.

launch a competing natural organic food chain to rival us....[Wild Oats] may not be able to defeat us but they can still hurt us.... [Wild Oats] is the only 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.

As it turns out, both Whole Foods’ self-promoting market characterizations (intended to tout its business model) and Mackey’s claims about how the merger would reduce price competition (intended to persuade board members to support the merger) were wrong. When the FTC finally got around to collecting and analyzing pricing data, it could show neither that premium natural and organic supermarkets constitute a market separate from conventional supermarkets nor that a combined Whole Foods/Wild Oats would be able to avoid price competition. Faced with the real world pricing data, the most the agency’s expert economist, University of Chicago professor Kevin Murphy, could conclude on the market definition question was that (1) Whole Foods and Wild Oats are close substitutes for one another, (2) there is significant competition between the two supermarkets, and (3) Whole Foods had a disciplining effect on Wild Oats’ prices.

That was not enough. No one ever doubted the first two conclusions, which are wholly irrelevant to the question of whether conventional grocers and other food sellers also compete with Whole Foods and Wild Oats. The third conclusion answers the wrong question: because the plan called for the merged firm to close Wild Oats stores after the merger, the relevant question would be whether Wild Oats stores (the ones to be eliminated) had a disciplining effect on Whole Foods’ pricing—not vice-versa. Murphy conceded that the data could not establish either that exit of a Wild Oats store led to higher prices at a neighboring Whole Foods or that entry of a Wild Oats store reduced prices at a nearby Whole Foods. Nor could the data show anything about how the entry or exit of conventional supermarkets affected Whole Foods’ pricing. (There are so many conventional supermarkets that it was impossible to find a geographic region where either a first conventional supermarket moved into a Whole Foods neighborhood or a last conventional supermarket moved out of the neighborhood.)

On the question of whether conventional supermarkets would respond to price increases at Whole Foods by expanding natural and organic offerings and enhancing services, Murphy could say almost nothing of substance. The fact is, con-
seeking organics. If that occurred, expansion of organic offerings would become profitable for conventional grocers. The fact that conventional supermarkets have not increased organic offerings with their current customer bases is irrelevant to whether they are poised to do so in response to a price increase.

**Substitution** In the end, the arguments by Murphy—a brilliant economist who made the strongest case he could, given the FTC’s untimely acquired pricing data—were stymied by key facts of which the FTC would have been aware had it examined pricing data prior to filing its complaint. As the district court explained, the available sales and pricing data showed:

1. Wild Oats prices are higher than Whole Foods prices where the two companies compete.
2. Whole Foods prices are essentially the same at all the stores in its region, regardless of whether there is a Wild Oats store nearby.
3. When Whole Foods does enter a new market where Wild Oats operates, Whole Foods takes most of its business from other retailers, not from Wild Oats.

Taken together, those three facts undermine the FTC’s insistence that Whole Oats uniquely constrains Whole Foods so that a merger of the two companies would injure consumers. The first fact suggests that Whole Foods’ effect on Wild Oats results from the former’s lower pricing, which is likely occasioned by the superior efficiency resulting from Whole Foods’ larger scale (which, of course, would increase with the merger). The second fact indicates that Whole Foods’ effect on Wild Oats’ pricing proves nothing about the degree to which Wild Oats’ presence constrains Whole Foods’ pricing. Given that the merger contemplates the closure of Wild Oats stores, not Whole Foods stores, that is the relevant constraining effect. The third fact suggests that consumers view Whole Foods as a competitive alternative to conventional grocery store chains, from which it usurps business.

Moreover, the FTC’s position ignored the fact that most customers of premium natural and organic supermarkets also shop regularly at conventional grocery stores. Given widespread cross-shopping, it would be nearly impossible for a combined Whole Foods/Wild Oats to raise prices on any item that was available at conventional grocery stores; customers would simply forgo purchasing that item on their Whole Foods trip and would instead purchase it on their trip to the conventional grocery store. As conventional grocery stores have beefed up their offerings of natural and organic products—a trend the FTC concedes—this cross-shopping has eliminated the opportunity for hiking prices on most individual items. Thus, to use economic jargon, it would be exceedingly easy for consumers and conventional grocery stores to respond to supracompetitive pricing by engaging in, respectively, demand and supply substitution.

Given the realities of the supermarket industry—realities of which the FTC would have been aware had it done its homework before filing its complaint—the district court concluded that Whole Foods and Wild Oats are not insulated from significant competition from conventional grocery store chains. Instead, they compete with conventional supermarkets and conventional supermarkets compete with them. When those other supermarkets are considered part of the relevant market, it becomes clear that the merger of two relatively small players in the much larger overall market would not give the combined firm the power to raise price and/or cut back on services, to the detriment of consumers. The district court therefore properly denied the FTC’s motion for preliminary injunction.

**Lessons from the FTC’s Challenge** While things worked out correctly this time around, one might deem the Whole Foods affair a near miss. Had the district court judge deciding the case been less economically sophisticated and more sensitive to “tough talk” in internal documents, this case could have come out differently. After all, the agency did uncover some inflammatory documents and managed to get one of the nation’s foremost economists to testify on its behalf. A less able or more distracted judge might not have recognized the weakness of the FTC’s claims.

It is thus worth asking what general lessons concerning merger review should be taken from the FTC’s failed attempt. Four come to mind:

**Lesson One:** “Hot documents” defining the market, demonstrating apparent motivation, or predicting effects should be irrelevant. As noted, the FTC did not collect detailed pricing information from Whole Foods and Wild Oats until after it had filed its complaint seeking to enjoin the merger. The initial basis for the agency’s position thus could not have been economic data showing that Wild Oats provides a unique constraint on Whole Foods. Instead, the agency chose to rely on internal Whole Foods documents suggesting that Whole Foods and Wild Oats compete in a distinct market and that competition would be reduced by the merger.

For example, in concluding that premium natural and organic supermarkets constitute a distinct market, the FTC initially did not look at the degree to which consumers would alter consumption patterns in response to higher prices. Instead, it relied on such documentary evidence as:

- Mackey’s statement that Whole Foods has “create[d] a customer loyalty that will not be stolen away by conventional markets who sell the same products,”
- Whole Foods’ assertion in its 2006 Annual Report that “[w]e believe our heavy emphasis on perishable products differentiates us from conventional supermarkets and helps us attract a broader customer base,”
- Mackey’s claim that “Whole Foods[,] core customers will not abandon them because Safeway has made their stores a bit nicer and is selling some organic foods,”
- An earnings announcement proclaiming that “Whole Foods Market is about much more than just selling ‘commodity’ natural and organic products. We are a lifestyle retailer and have created a unique shopping environment built around satisfying and delighting our customers,” and
Documents in which Mackey claimed that “people who think organic foods are the key don’t understand [Whole Foods''] business model” and that “organic food is only part of [Whole Foods] highly successful business model.”

Besides relying on internal documents to define the relevant market, the FTC also pointed to such documents as establishing the merger’s anticompetitive purpose and effect. Indeed, the third sentence of the complaint alleges: “Whole Foods’ Chief Executive Officer John Mackey bluntly advised his board of directors of the purpose of this acquisition” and then proceeds to quote Mackey’s aforementioned e-mail about “avoid[ing] nasty price wars” and “eliminat[ing] forever the possibility of Kroger, Super Value, or Safeway using their brand equity to launch a competing natural organic food chain to rival us.”

In the end, though, the FTC’s document-based inferences about market definition and competitive effect were undermined by real-world pricing data. That should not be surprising. Business people routinely make puffing claims about the uniqueness of the product or service they are selling, and it would be naïve to infer from such self-serving claims that the products or services at issue really are so unique that the seller could raise prices above competitive levels without causing buyers to substitute toward alternatives. Whole Foods’ claim to be a “lifestyle retailer” offering “a unique shopping environment” says next to nothing about whether shoppers would really refrain from substituting to, say, a Safeway Lifestyle Market in response to a price increase. Similarly, aggressive “fighting words” in internal communications generally say little about the real purpose of planned conduct — much less the likely effect of such conduct. For example, the inflammatory “avoid nasty price wars” language quoted at the beginning of the FTC’s complaint appeared in a last-minute e-mail that was designed to drum up board support for the Wild Oats merger. One could not infer the true purpose of the merger from this out-of-context snippet and, even if one could, it is effect — not purpose — that really matters. Divining likely effect requires a hard look at economic data rather than consideration of statements lifted out of context.

Geoff Manne and Marc Williamson have persuasively criticized the use of “hot docs” in antitrust enforcement. They observe that accounting documents, market definition documents, and documents containing “fighting words” frequently give rise to economically inaccurate inferences and are highly prejudicial, but they are nonetheless routinely used in antitrust enforcement and adjudication. Under modern discovery rules, such documents are readily available to regulators and litigants, causing a “the light’s better over here” problem (i.e., the difficulty confronting the drunkard who searches for his lost keys under the streetlamp, not because that is where he left them, but because “the light’s better over here”).

With respect to market definition documents, the Supreme Court exacerbated this problem by stating in the Brown Shoe case that submarkets could be defined, in part, according to such “practical indicia” as “industry or public recognition of the []market as a separate economic entity, the product’s peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.” This unfortunate statement invited litigants and regulators to scour business documents for market characterizations that suit their end. Unfortunately, those characterizations are frequently inaccurate, and reliance on business documents rather than econometric evidence often leads to mistakes. As Manne and Williamson put it:

Business people will often characterize information from a business perspective, and these characterizations may seem to have economic implications. However, business actors are subject to numerous forces that influence the rhetoric they use and the conclusions they draw. These factors include salesmanship; self-promotion; the need to take credit for successes and deny responsibility for failures; the need to develop consensus; and the desire to win support for an initiative or to neutralize its opponents.... Simply put, the words and procedures used by business people do not necessarily reflect “economic realities,” and the effort to integrate them further into antitrust analysis is misdirected.

LESSON TWO: Unique distribution channels should not be deemed “markets” unless they significantly reduce transaction costs.

In the Whole Foods case, the FTC never claimed that the relevant market was natural and organic grocery products. Because such goods are widely available from a multitude of sellers, defining the market as such would have doomed the FTC’s challenge out of the gate. Instead, the agency asserted that the relevant market consisted of premium natural and organic supermarkets.

Defining the market to consist of narrow channels of distribution, notwithstanding the fact that the same merchandise sold through those channels is readily available in parallel distribution markets, is a tack the agency has taken before — most notably in FTC v. Staples, Inc., in which the agency successfully blocked the merger of retailers Staples and Office Depot on grounds that it would impair competition in the market for “the sale of consumable office supplies through office superstores.” In the Whole Foods case, though, the approach was improper. Antitrust regulators should define markets to consist of distribution channels only when such channels significantly economize on transaction costs.

Like the unfortunate reliance on “hot documents” in merger analysis, the characterization of unique distribution channels as antitrust markets can be traced to Brown Shoe’s discussion of submarkets. In that case, the Supreme Court stated that “well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes.” It then posited the aforementioned “practical indicia” (industry or public recognition, peculiar characteristics, distinct customers, specialized vendors, etc.) for determining whether such a submarket exists. Latching onto this discussion, lower courts and regulators have largely relied on casual observations and “bunches” to determine whether distribution channels are unique enough to constitute distinct markets for antitrust purposes. That is unfortunate, for
economic theory offers a less arbitrary, more structured means of accurately determining when unique distribution channels should be deemed antitrust markets.

A proper analysis would begin by asking what is being provided by the participants in a putative market consisting of distribution channels. The answer, of course, is the service of conveying goods from one link in the distribution chain to another. (Technically, then, the market in the Whole Foods case could not have been premium natural and organic supermarkets themselves, which were not for sale to customers, but premium natural and organic supermarket services.) In the case of distinctive retailers like premium natural and organic supermarkets, the primary service is the aggregation of various products and services that are generally available elsewhere. The proper question, then, is whether the sellers of a substantial transaction cost savings for consumers. In such a case, the distribution channel could constitute a unique market, despite the fact that the products being distributed are widely available through parallel distribution channels. But if the distribution channel does not result in significant transaction cost economies and the products at issue are available through other channels, the channel itself should not be deemed a separate market. The key question, then, is whether the use of a seemingly unique distribution channel for otherwise widely available products occasions substantial transaction cost savings for consumers.

With respect to premium natural and organic supermarkets, the answer to that question is almost certainly no. Because premium natural and organic supermarkets do not stock many popular grocery items (Diet Coke and Cheerios come to mind), many of their customers also shop regularly at conventional grocery stores. This suggests that, for many customers, the transaction cost savings offered by premium natural and organic supermarkets are not that great; the customers must shop at two stores to procure the groceries they desire. Accordingly, if all premium natural and organic supermarkets were to raise the effective price of their aggregation service by raising the prices of the products they sell — most of which are available at stores many of their customers already visit — those cross-shopping customers would just start buying the price-enhanced products at other stores. Doing so would not significantly increase the transaction costs associated with cross-shopping customers’ grocery shopping. In short, the fact that premium natural and organic supermarkets do not facilitate one-stop shopping for many consumers, and thus do not offer significant transaction cost savings to those consumers, prevents such stores — admittedly a distinctive distribution channel — from being a separate market for antitrust purposes. The Whole Foods case thus illustrates the need for courts and regulators to adhere to an economically informed theory of when unique distribution channels for otherwise widely available products may constitute a relevant market.

**LESSON THREE: Merger analysis should better account for business trends and productive efficiencies.**

In deciding whether to challenge a proposed merger of competitors, the FTC and the Department of Justice follow guidelines the agencies jointly issued in 1992 and amended in 1997. Under those guidelines, the reviewing agency begins by defining the market in which the merging competitors participate. The agency then measures the degree of concentration in that market and the degree to which the merger would enhance market concentration. Based on those measurements, the agency determines the level of scrutiny to be applied. Mergers are subjected to greater scrutiny if they occur in markets that are already concentrated and occasion larger increases in market concentration.

After defining the market, assessing concentrations, and determining the level of scrutiny to be applied, the reviewing agency considers four additional matters to determine whether the merger will hurt consumers. It examines qualitative factors about the market at issue to determine whether the merger could facilitate collusion by the remaining firms in the market or could permit the merged firm to raise price or reduce quality unilaterally. The agency analyzes whether a price increase or quality reduction would likely result in timely entry by competitors, so that the merged firm could not harm consumers by raising price or reducing quality. It asks whether the merger will occasion such large productive efficiencies (by, for example, enabling the merged firm to achieve economies of scale) that
consumers are likely to be benefited despite an increase in market power. And it considers whether one or both of the merging parties would fail if the merger were not accomplished.

While the merger guidelines represent a tremendous improvement on standardless “black box” merger review, the guidelines—at least as implemented—are deficient in at least two respects. First, they result in an overly static analysis that fails to account for trends in consumption and production. Market definition is determined primarily on the basis of how consumers would respond to price increases, and that is determined by looking at how consumers have acted in the past. Such an approach cannot take account of changing trends in consumer behavior. Thus, in examining (and deciding to challenge) the proposed merger of Blockbuster Video and Hollywood Video, the FTC did not adequately account for the fact that video consumers are moving away from big box rental stores and toward Internet-based options such as Netflix or direct downloading of video content. A snapshot based on what consumers have done in the past may present a misleading portrayal of how they will react to future price increases.

By the same token, trends in supplier conduct are important but often ignored. In theory, the merger guidelines contemplate that the reviewing agency will take account of supplier trends, for they call for the agency to include within the relevant market “uncommitted entrants” that would likely enter the market in response to a price increase. As the Whole Foods case shows, though, the agencies often fail to account for the fact that businesses are already moving into the market space occupied by the merging companies. Indeed, the June 6, 2007, front page of the very Wall Street Journal issue announcing the FTC’s opposition to the Whole Foods/Wild Oats merger also reported that a number of conventional grocery chains are transforming their stores to provide a more Whole Foods–like experience:

After years of decline brought on by fighting Wal-Mart Stores Inc. on price, the nation’s grocery chains are on the mend. The supermarkets are winning back shoppers by sharpening their differences with Wal-Mart’s price-obsessed supercenters, stressing less-hectic stores with exotic or difficult-to-match products and greater convenience.... Subdued lighting and high-end selections buttress the supercenter experience. Instead of the rows of aisles with commonplace brands, the supermarkets are adding tables providing ingredients for planned meals, luring the kind of customer who shops for dinner instead of stocking up on groceries once a week.... Safeway Inc. has converted about half of its 1,755 stores into “Lifestyle” markets with wood floors, on-site bakeries and high-end private-label brands. The third largest food retailer after Wal-Mart and Kroger, it expects to convert all its stores by 2009.

While the merger guidelines recognize that “[m]arket concentration and market share data of necessity are based on historical evidence” and assure that “[t]he [reviewing] Agency will consider reasonably predictable effects of recent or ongoing changes in market conditions in interpreting market concentration and market share data,” the Whole Foods case shows that actual practice falls short of this ideal. The agencies should recommit themselves to a less static analysis.

In addition, the agencies should take greater account of the productive efficiencies a merger will occasion. While the merger guidelines contemplate consideration of productive efficiencies (albeit fairly late in the analysis), the Whole Foods case suggests they play a minor role. The FTC never mentioned productive efficiencies (or the lack thereof) in its complaint and they played no role whatsoever in its expert’s analysis. The FTC commissioned Murphy to answer six questions, none of which involved consideration of productive efficiencies the merger might occasion. That is odd, for grocery retailing is an industry involving substantial economies of scale, implying that a larger merged firm will tend to have lower per-unit costs than the smaller firms of which it is comprised. Indeed, the 800-pound gorilla of grocery retailing is Wal-Mart, whose vast size enables it to capture scale economies and thereby underprice its rivals. (Wal-Mart’s entry into the conventional grocery market was followed by a slew of bankruptcies—26 this decade—by smaller, regional grocery store chains that could not capture such efficiencies and thus could not compete with Wal-Mart on price.) Without doubt, a merged Whole Foods/Wild Oats will have lower per-unit costs than either company pre-merger, and much of the cost-savings will likely be passed on to consumers. The fact that Whole Foods, the larger of the two premium natural and organic supermarket chains, charged lower prices than Wild Oats illustrates how scale in this industry can lower costs and prices. The FTC’s public documents, though, never even acknowledged economies of scale.

**LESSON FOUR: The deck should not be stacked so heavily in favor of the FTC.**

Section 13(b) of the Federal Trade Commission Act authorizes the FTC to seek a preliminary injunction against a merger that may violate the antitrust laws. The section then provides that the court should issue the requested preliminary injunction if the Commission makes “a proper showing that, weighing the equities and considering the Commission’s likelihood of ultimate success, such action would be in the public interest.” This language has been interpreted to mean that the FTC should get its preliminary injunction if it shows that it “likely” could prove that the merger would violate the antitrust laws—in other words, that it has at least a 50 percent chance of ultimately proving that the merger would violate the antitrust laws.

This lax standard becomes troubling when one considers what the FTC must prove in order to establish that the merger would in fact violate the antitrust laws. The relevant legal provision here is Section 7 of the Clayton Act, which forbids any merger that “may substantially lessen competition.” As the Brown Shoe Court noted, “Congress used the words ‘may be substantially to lessen competition’ (emphasis supplied), to indicate that its concern was with probabilities, not certainties.” Courts interpreting Section 7 have held that a merger violates the law if there is a “reasonable probability” that it would substantially lessen competition. Thus, any merger posing a 50 percent chance of substantially lessening competition violates the substantive antitrust laws.
Taken together, Section 13(b) of the FTC Act and Section 7 of the Clayton Act set a remarkably low threshold for obtaining a preliminary injunction: The FTC must establish only a 50 percent likelihood that there is a 50 percent chance that the merger would substantially lessen competition. This effectively means that a preliminary injunction may be granted if the FTC can show facts establishing a 25 percent likelihood that the challenged merger will substantially reduce competition.

Of course, one might argue that this low proof threshold is acceptable for a preliminary injunction, which bars the merger only until the court can determine whether the merger would actually violate Section 7 (i.e., until the FTC actually proves that the merger would pose at least a 50 percent likelihood of substantially lessening competition). But given the tenuous nature of merger agreements, the granting of a preliminary injunction effectively kills the deal. As David Balto, former policy director of the FTC’s Bureau of Competition, recently observed:

The reality is that no firm has ever continued to litigate a merger against the FTC after losing the preliminary injunction motion. The costs and difficulty of keeping a merger agreement together are simply too great. As Justice Fortas observed, in FTC v. Dean Foods, “Preliminary here usually means final.”

Notably, because of some statutory quirks, mergers challenged by the Justice Department, the other federal agency charged with evaluating whether proposed mergers violate the antitrust laws, cannot be effectively thwarted on so slight a showing. The bipartisan Antitrust Modernization Commission recently observed that differences between the two agencies’ pre-merger reviews “can undermine the public’s confidence that the antitrust agencies are reviewing mergers efficiently and fairly.” The commission recommended that the FTC consolidate its requests for preliminary and permanent injunctive relief, a move that would effectively eliminate the overly low standard for officially “preliminary” — but in effect permanent — injunctions. The Whole Foods case demonstrates the wisdom of raising the standard of proof for injunctive relief.

A SILVER LINING?

Although Whole Foods and Wild Oats have already consummated their merger, the FTC has taken the highly unusual step of appealing the district court’s denial of its motion for preliminary injunction. That may actually be a good thing — not because the district court’s substantive analysis was wrong (it was not), but because an appeal could have a salutary effect on future merger analyses.

Very few merger challenges are appealed. When regulators lose, they generally do not appeal because mergers usually close shortly after the district court rules, and most consummated mergers are quite difficult to undo. When the parties to a merger agreement lose, they usually give up because they know they probably cannot hold the merger agreement together for the duration of an appeal. The result has been a dearth of Supreme Court merger decisions; the last significant one was United States v. General Dynamics Corp., decided in 1974.

With the Whole Foods case, the FTC concluded that the combined company’s decision to operate Wild Oats stores separately for some period of time would avoid the need to engage in a messy disentangling of the merged company should the agency prevail on appeal. Thus, the FTC has appealed.

There is a good chance the current Supreme Court will agree to hear an appeal if the case proceeds that far. Unlike the Rehnquist Court it succeeded, the Roberts Court has shown significant interest in antitrust matters. Indeed, in the last two terms, the Court decided seven antitrust cases, compared to an average of less than one per year in the 15 years prior to the 2003–2004 term.

If the Court is presented with an appeal of a merger decision, it might well take the opportunity to correct some of the unfortunate vestiges of Brown Shoe. That decision appears to bear at least some responsibility for two of the errors the FTC committed in the Whole Foods case. Both the unwarranted reliance on “hot documents” and the improper focus on the unique appearance of particular distribution channels (rather than the degree, if any, to which those channels reduce transaction costs and thereby provide a unique service) might have been supported by Brown Shoe’s invitation to determine market boundaries according to non-economic “practical indicia.” A Supreme Court merger decision emphasizing that markets should be defined entirely on the basis of economic factors would provide much-needed clarification and would prevent much future mischief. In addition, a Supreme Court merger decision could emphasize the importance of considering productive efficiencies in determining whether a merger should be challenged. While the 1997 amendments to the merger guidelines moved in the right direction by expressly calling for consideration of such efficiencies, the guidelines do not consider them until rather late in the analysis and, as the Whole Foods case would suggest, they are sometimes ignored altogether. The Supreme Court could remind regulators that such efficiencies should play a key role in the analysis of proposed mergers. And, while statutory amendment is likely required to correct the unduly low standard of proof required for FTC-initiated preliminary injunctions, a Supreme Court decision highlighting the lax standard (and the discrepancy between the FTC and Department of Justice standards) could spur Congress to adopt the Antitrust Modernization Commission’s suggestion that the FTC preliminary injunction standards be brought into line with those applicable to the Department of Justice.

So there may be a silver lining to the FTC’s intervention in the Whole Foods/Wild Oats merger. Hopefully, the Whole Foods case will afford the federal court of appeals — or perhaps even the Supreme Court — an opportunity to clean up merger doctrine so that the lessons of the Whole Foods case get incorporated into merger doctrine.

Readings

- “Hot Docs vs. Cold Economics: The Use and Misuse of Business Documents in Antitrust Enforcement and Adjudication,” by Geoffrey A. Manne and E.