

Client Alert

A report
for clients
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of the Firm July 2008

D.C. Circuit Reverses Denial of Preliminary Injunction in FTC Action against Whole Foods Acquisition of Wild Oats

On July 29, 2008, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit reversed, in a 2-1 decision, the district court's August 2007 decision denying the Federal Trade Commission's ("FTC") application for a preliminary injunction against Whole Foods Market, Inc.'s ("Whole Foods") acquisition of Wild Oats Markets, Inc. ("Wild Oats"). *F.T.C. v. Whole Foods Market, Inc.*, --- F.3d --- Case No. 07-5276 (D.C. Cir. July 29, 2008). The DC Circuit's decision reaffirms the standard for grant of a preliminary injunction under Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), and holds that where price discrimination is possible, core customers are deserving of antitrust protection even if marginal customers would switch to other sources of supply in the event of a noncompetitive price increase.

Action Not Moot

Whole Foods consummated its tender offer acquisition of Wild Oats on August 28, 2007, five days after the DC Circuit denied the FTC's emergency motion for an injunction pending appeal. *FTC v. Whole Foods Market, Inc.*, No. 07-5276 (D.C. Cir. Aug. 23, 2007). Nevertheless, and although Whole Foods has now sold, closed or converted to Whole Foods establishments many of the Wild Oats stores, the DC Circuit decision filed by Circuit Judge Janice Rogers Brown held that the FTC's preliminary injunction action is not moot,

because "[a]t a minimum, the courts retain the power to preserve the *status quo nunc*, for example by means of a hold separate order, and perhaps also to restore the *status quo ante*."¹ Noting that the FTC had identified antitrust concern in 18 different local markets, the DC Circuit observed that "[i]f, as appears to be the situation, it remains possible to reopen or preserve a Wild Oats store in just one of those markets, such a result would at least give the FTC a chance to prevent a § 7 violation in that market."

The Preliminary Injunction Standard under the FTC Act

Unlike the Department of Justice, which tries its merger cases in the same district court in which it may seek preliminary injunctive relief, the FTC typically turns to the court only to preserve the *status quo ante* and adjudicates the case through an administrative proceeding before the FTC.² The merging parties may appeal an adverse decision by the FTC to a United States circuit court, and a preliminary injunction is effective only until the FTC dismisses the action or a circuit court rules on the FTC's decision.

The FTC creates a presumption in favor of preliminary injunctive relief, the DC Circuit explained, by "rais[ing] questions going to the merits so serious, substantial, difficult[,] and doubtful as to make them fair ground for thorough investigation."³ The DC Circuit reaffirmed that in ruling on an FTC request for preliminary injunction blocking a merger under Section 13(b) of the FTC Act, the district court must balance the likelihood of the FTC's ultimate success against the equities, under a sliding scale; the greater the likelihood of the FTC's success, the stronger the equities weighing in favor of the merger required to overcome the FTC's showing. The DC Circuit noted that "[t]he equities will often weigh in favor of the FTC, since 'the public interest in effective enforcement of the antitrust laws'

¹ Citing *FTC v. Weyerhaeuser Co.*, 665 F.2d 1072, 1084 (D.C. Cir. 1981).

² The FTC issued its administrative complaint against Whole Foods and Wild Oats on June 28, 2007, and, on August 7, 2007, stayed the administrative proceedings pending the proceedings in the collateral federal district court case.

³ Citing *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 714-15 (D.C. Cir. 2001).

was Congress’s specific ‘public equity consideration’ in enacting [Section 13(b)].”⁴

The Alleged Relevant Market – Premium Natural and Organic Supermarkets

The district court did not consider the equities under the sliding scale, because it had rejected the product market alleged by the FTC—premium natural and organic supermarkets (“PNOS”)—and ruled that the market includes at least all supermarkets. Having concluded that there is no likelihood that the FTC can prove its asserted product market, the district court found no likelihood that the FTC could prove that the proposed merger may substantially lessen competition or tend to create a monopoly. Therefore, the district court found it unnecessary to consider the equities and the public interest.

Citing the FTC’s reliance on market definition in its presentation to the district court, the DC Circuit rejected the FTC’s argument on appeal that the FTC could prove its case without defining a market. However, the DC Circuit acknowledged that at the preliminary injunction stage the FTC may have alternative theories of anticompetitive harm which depend on inconsistent market definitions. Further, the DC Circuit noted, where a merger between two close competitors raises antitrust concerns due to unilateral effects in highly differentiated markets, “it might not be necessary to understand the market definition to conclude a preliminary injunction should issue.”

In a two-day hearing before the district court, the parties’ respective economic experts, Dr. Kevin Murphy for the FTC and Dr. David Scheffman, Jr. for Whole Foods, were examined by counsel and by the court. Dr. Scheffman presented a “critical loss analysis” which showed, based on Whole Foods’ margins, the percent loss of sales that would make a small price increase unprofitable. Dr. Scheffman inferred that Whole Foods would lose more than this volume of sales if it raised prices following the acquisition. Dr. Murphy presented a diversion analysis, which showed that a hypothetical PNOS monopolist could profitably close Wild Oats stores, because, according to Whole Foods’ internal planning documents, at least a majority of Wild Oats customers would switch to Whole Foods if a nearby Wild Oats store closed. These analyses highlighted the dispute between the parties, with Whole Foods arguing that it could not afford to lose marginal customers who would switch to conventional supermarkets and the FTC arguing that core PNOS customers would be harmed by the elimination of competition between Whole Foods and Wild Oats. The district court concluded that “the effect of the proposed

merger on marginal consumers is more important than the effect on such core consumers, as it is the marginal consumers for whom the stores must and do compete most vigorously.”⁵

The DC Circuit found that the district court “ignore[d] FTC evidence that strongly suggested Whole Foods and Wild Oats compete for core consumers within a PNOS market, even if they also compete on individual products for marginal consumers in the broader market.” The circuit court observed that “the FTC documented exactly the kind of price discrimination that enables a firm to profit from core customers for whom it is the sole supplier.” Specifically, the court noted, “in the high-quality perishables on which both Whole Foods and Wild Oats made most of their money, they competed directly with each other, and they competed with supermarkets only on the dry grocery items that were the fringes of their business.” By charging higher prices for perishables, Whole Foods could extract profits from the majority of its customers, *i.e.*, the core customers who share Whole Foods’ commitment to organic and natural.

The DC Circuit concluded that the FTC had shown a likelihood of success that it could prove a PNOS submarket:

The FTC described the core PNOS customers, explained how PNOS cater to these customers, and showed these customers provided the bulk of PNOS’s business. The FTC put forward economic evidence—which the district court ignored—showing directly how PNOS discriminate on price between their core and marginal customers, thus treating the former as a distinct market.

In his concurring opinion, Circuit Judge David S. Tatell observed that the district court “overlooked or mistakenly rejected evidence supporting the FTC’s view that Whole Foods and Wild Oats occupy a separate market of [PNOS]” and that “at this preliminary, pre-hearing stage, the pricing [and] other evidence . . . is certainly enough to raise ‘serious, substantial’ questions that are ‘fair ground for thorough investigation, study, deliberation, and determination by the FTC.’”⁶ Further, Judge Tatell pointed to economic literature that casts doubt on the critical loss analysis conducted by Whole Foods’ economic expert, pointing out that while high margins yield a low critical loss calculation they imply that the actual loss is also likely to be low.

In his dissent, Circuit Judge Brett M. Kavanaugh endorsed the analysis of the district court, agreed with the district court that Whole Foods competes against all supermarkets, and noted that “Whole Foods and Wild Oats together operate only about 300 of the approximately 34,000 supermarkets in

⁴ Citing *Heinz*, 246 F.3d at 726.

⁵ *FTC v. Whole Foods Market*, 502 F. Supp. 2d 1, 23 (D.D.C. 2007).

⁶ Citing *Heinz*, 246 F.3d at 714-15.

the United States.” Judge Kavanaugh observed that the FTC confused differentiation with separate product markets: “These are not separate product markets; this is a market where all supermarkets including so-called organic supermarkets are clawing tooth and nail to differentiate themselves, beat the competition, and make money.” Judge Kavanaugh concluded that while “there may be consumers who are so wedded to Whole Foods that they’ll pay much higher prices”, there are not enough such consumers that Whole Foods can profitably increase price.

Case Remanded to the District Court

The DC Circuit remanded the case to the district court to balance the equities “considering the circumstances of this case, including the fact that the merger has taken place.”

Conclusion

The DC Circuit’s decision reinforces the principle that consistent with Section 13(b) of the FTC Act, when the FTC seeks a preliminary injunction to preserve the status quo, the FTC is not required to prove its underlying antitrust case in district court. The FTC is only required to demonstrate a sufficient likelihood of success to show that it is in the public interest to preserve the status quo pending completion of the FTC’s investigation and administrative adjudication.

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