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Whole Foods-Wild Oats Deal Leaves Controversial Legacy

Jenna Greene
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As corporate mergers go, the purchase of natural foods grocer Wild Oats by its rival Whole Foods Market looked like small potatoes (organic yellow fingerling, perhaps). Nobody expected the proposed \$565 million acquisition to spark a food fight of epic proportions.

But on March 6 -- after two years, \$28 million in legal fees and expenses, and dozens of lawyers -- Whole Foods cut a deal to end the battle. And the Federal Trade Commission carved another notch in its reputation for aggressive antitrust enforcement.

The most important result of the battle may be a controversial opinion out of the U.S. Court of Appeals for the D.C. Circuit that some fear will make it too easy for the FTC to effectively block future mergers. As one antitrust expert says, "so long as their lawyers don't get up there and fall asleep at the podium," the FTC wins. Less than a week after Whole Foods and the FTC settled, a \$1.4 billion merger collapsed in part due to the D.C. Circuit opinion.

As for the dispute over merging grocery chains, it's not clear who actually won. The FTC, which snatched significant concessions from the jaws of initial defeat, asserts it came out on top. "Obviously, [the settlement] wasn't the maximum relief we could have obtained," says David Wales Jr., acting head of the FTC's Bureau of Competition, discussing the case at length for the first time. "But we feel it substantially restores competition and did so a lot sooner than if we had continued to litigate."

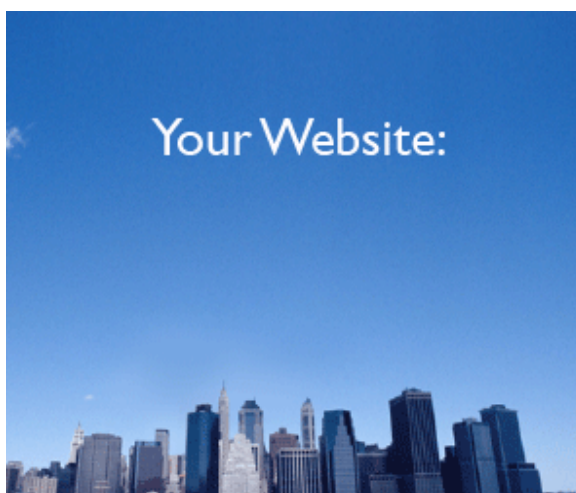
Whole Foods points out that the merger survived; it wasn't forced to unscramble all the eggs. "It was a settlement -- nobody got what they wanted," says lead lawyer Paul Denis, a partner in Dechert's D.C. office. "If everybody leaves unhappy, you must have gotten it right."

Still, agreeing to divestitures in the face of an antitrust agency's opposition looks a lot like business as usual. Why did Whole Foods spend so much money to reach that settlement? In retrospect, the company may have been too determined to go [toe to toe with the FTC](#) -- and caught off-guard by the FTC's similarly battle-ready approach.

GOING FROM 0 TO 60

When the merger between the two grocery chains was announced on Feb. 21, 2007, analysts' reaction was largely positive. UBS called it "a slam dunk," while Morningstar said it was "strategically and financially sound." No one, it seems, had any inkling of the antitrust train wreck ahead. Standard & Poor's was lukewarm on the deal for the opposite reason: The stores faced "increased competition from traditional grocers."

Whole Foods, which is based in Austin, Texas, didn't even start off with specialized antitrust counsel -- it used its M&A lawyer, Bruce Hallett of Dallas' [Hallett & Perrin](#), to submit the required pre-merger notification, a 15-page



form with information about each company's business. Whole Foods, with 194 stores, would buy Boulder, Colo.-based Wild Oats, which owned 110 stores total, 74 of them under the Wild Oats brand, for \$18.50 per share of stock. The two chains were prime competitors in just 22 markets.

While the FTC and the Justice Department's Antitrust Division sometimes fight over which agency will review a merger for its potential effects on competition, supermarket mergers have always gone to the FTC. "In the overwhelming majority of cases, it makes absolutely no difference which agency reviews a merger," says Ronald Wick, an antitrust partner at Baker Hostetler not involved in the case.

But as Whole Foods would soon discover, sometimes differences in the two agencies' statutory authority can prove crucial.

The filing was routed to the FTC Mergers IV group, which specializes in retail sector transactions. The deal, Wales says, "quickly jumped out as having potential overlap, potential competitive significance." A partner at Cadwalader, Wickersham & Taft before joining the FTC in 2006, Wales, 39, has been acting director of the Bureau of Competition since Jeffrey Schmidt left in August 2008.

A team quickly took shape. Mergers IV lawyers led by Assistant Director Matthew Reilly began gathering information, talking to the parties, their competitors, and their customers. Less than three weeks later, on March 13, 2007, the agency issued a second request for documents. "It was not a close call," Wales says.

Even before the second request was officially made, Whole Foods got the hint that trouble loomed. But in seeking experienced counsel, it still looked for a familiar firm. The company turned to antitrust lawyer Neil Imus and commercial litigator Alden Atkins, partners in the D.C. office of Houston-based [Vinson & Elkins](#). Atkins had previously handled litigation for Whole Foods involving a store in Washington, D.C. Although Whole Foods would run the litigation, Wild Oats retained Clifford Aronson of New York's [Skadden, Arps, Slate, Meagher & Flom](#).

If settlement with the FTC was desirable or even possible at that point, Whole Foods' lawyers had little time to explore the option. They were too busy fulfilling the second request. The companies turned over 16.5 million pages of material, one of the largest document productions in recent agency history. While once this would have meant 10,000 boxes stacked in a conference room, the data largely came on hard drives -- along with a computer virus. ("Obviously we didn't think they did it on purpose," Wales says). Dozens of FTC staff lawyers began their review.

Then on June 6, 2007, the FTC filed suit in U.S. District Court for the District of Columbia seeking a preliminary injunction to halt the merger. All five commissioners -- three Republicans, one Democrat, and one independent -- voted in favor of bringing the case.

THE MARKET FOR ARUGULA LOVERS

The 16-page complaint focused on statements from Whole Foods CEO John Mackey that made clear how he assessed the real competitive threat. In an e-mail to his board of directors Mackey bluntly wrote that buying Wild Oats was a way to "avoid nasty price wars. ... [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."

During the investigation, the agency also discovered that for years, Mackey had been posting about Whole Foods -- and sometimes Wild Oats -- on a Yahoo bulletin board using the name "Rahodeb." The FTC revealed his identity in a footnote in the June 6 court papers. While the revelation sparked a Securities and Exchange Commission investigation (eventually dismissed), it had little effect on the antitrust case.

"It was never about trying to embarrass him," Wales says. "But obviously it was important to know that the founder and CEO of the company was saying these things -- his views on the market and the competition."

If Whole Foods and Wild Oats operated regular supermarkets, the deal could hardly be seen as anti-competitive -- not when there are about 34,000 other grocery stores in the United States. But neither the FTC nor, the agency argued, the two companies defined the relevant market that way. As former Wild Oats CEO Perry Odak would put it in a deposition, "There's really only two players of any substance in the organic and all-natural [market], and that's Whole Foods and Wild Oats. ... [T]here's really nobody else in that particular space."

So in its complaint, the FTC laid out a new market definition: the premium, natural, and organic supermarket. The FTC described such stores as focusing on "perishable products, offering a vast selection of very high quality fresh fruits and vegetables -- including exotic and hard-to-find items." The stores target affluent, well-educated shoppers and offer more amenities and a higher level of service. They also "promote a lifestyle of health and ecological sustainability." Under this definition, the merger of Whole Foods and Wild Oats created a near-monopoly.

The leading precedent for constructing such a narrow market definition comes from the FTC's successful 1997 challenge to the merger of Staples and Office Depot. Although pens, pencils, and paper clips are sold in many places, the FTC convinced the court that office supply superstores constituted a distinct market. Key to the victory were FTC data showing prices were much higher in markets with only one superstore.

The FTC couldn't come up with such clear-cut data in the Whole Foods case. "We had a more complicated story to tell about pricing," is how Wales puts it. The FTC hired University of Chicago Business School professor Kevin

Murphy as its expert economist. He found that Whole Foods profit margins were lower in cities that also had a Wild Oats, but only by 7/10 of 1 percent.

With such weak price data, FTC lawyers had their work cut out for them. The agency's recent record in stopping mergers has been at best mixed, and the FTC was roundly criticized for bringing the Whole Foods case. A Wall Street Journal editorial called the complaint "shoddy and sophomoric." The Chicago Tribune jeered that the agency was focusing on "the number of outlets for organic arugula" rather than "protecting consumers from actual harm."

Wales says, "We read the papers, we were aware of [the criticism], but it really did not have an impact."

In addition to the federal case, the FTC also issued an administrative "Part III" complaint (subsequently stayed). Although not immediately important, the threat of an in-house trial would come to weigh heavily on Whole Foods later in the case.

A SLAM DUNK

In anticipation of the showdown in federal court, Whole Foods again beefed up its legal team. For the company, it would become something of a pattern to throw new and more prominent lawyers at the case whenever setbacks loomed.

A little over a week after the complaint was filed -- and a bare six weeks before the hearing was scheduled -- the company hired Paul Denis of [Dechert](#) to serve as lead counsel, although Vinson & Elkins lawyers continued to assist. Low-key with a dry sense of humor, Denis is well-regarded in the tight-knit antitrust community. Like many other antitrust partners at large law firms in Washington, he did a stint in the government, working as counselor to then-Antitrust Division head James Rill from 1989 to 1992. Now age 50, Denis has built a solid private-sector résumé, handling deals including Suiza Food Corp.'s \$2.5 billion acquisition of Dean Foods Co.

One of his clients recommended him to Whole Foods, he says, and he flew to Austin for an introductory meeting with general counsel Roberta Lang. Denis recalls sitting in a Whole Foods conference room and spying a map on the wall that he recognized as Rockville Pike in Maryland. It was a site selection study for a new Whole Foods store that showed the locations of surrounding supermarkets such as Giant, Safeway and Trader Joe's. "I asked, 'Can I have that?'" he says, "and I used it as one of the visuals in our closing argument." The point, he explains, was that if the only competitor that mattered was Wild Oats, "why would Whole Foods spend all this time studying all these supermarkets, down to the number of parking spots and cash registers, on Rockville Pike?"

It was a cornerstone of Denis' strategy to argue that Whole Foods faced vigorous and growing competition from a variety of supermarkets as well as retailers like Wal-Mart, which have all been adding more organic and natural foods to their stores. Still, as the FTC stressed, Mackey himself had repeatedly undermined this contention. "Whole Foods core customers will not abandon them because Safeway has made their stores a bit nicer and is selling some organic food," Mackey wrote in one example cited in the June 6 complaint.

Accustomed to being hired much earlier in the antitrust review process, Denis threw himself into the case, working "nonstop, seven days a week" to prepare, he says. He boiled the case down to its essentials, then wrote a two-page memo titled "Why we win" and distributed it to the 18 Dechert lawyers working with him. The overriding theme: stay grounded in actual marketplace behavior. Pricing, site selection, monitoring of competitors -- Whole Foods behaved the same way whether there was a Wild Oats nearby or not. "If the FTC was right, there should have been a difference," Denis says.

After expedited discovery, the district court hearing took place on July 31 and Aug. 1, 2007. The primary FTC trial lawyers were Reilly of Mergers IV, Michael Bloom, Jeffrey Perry, and Albert Kim. There were no live witnesses giving direct testimony, only cross-examination of expert witnesses. Denis argues that strategically, this arrangement favored the government, which had actually suggested that all testimony be done on paper. "I would have preferred to have live witnesses," he says. "Real people who ran the business and could talk coherently about what they did."

In retrospect, Wales isn't so sure excluding direct witnesses was an advantage even for the FTC. "We felt the arrangement was a good way to present our evidence, but it may have taken some of the judge's focus off the Whole Foods documents," he says.

The Dechert team used extensive computer slides with graphics and hyperlinks to help illustrate key points. The one Denis kept coming back to, adding a new fact each time, compared Whole Foods-Wild Oats to Staples-Office Depot. "In the right case [Staples], the FTC can and did assemble the proof. The contrast was quite striking," he says.

On Aug. 16, Judge Paul Friedman released his decision, a 93-page opinion backing Whole Foods and denying a preliminary injunction. The judge didn't buy the FTC's narrow market definition and supported the findings of Whole Foods' expert economist that even if the chain did try to raise prices, it wouldn't pay off because so many customers would simply shop elsewhere. "There is no substantial likelihood that the FTC can prove its asserted product market and thus no likelihood that it can prove the proposed merger may substantially lessen competition," he ruled.

Wales says the decision came as a shock. "It can be hard to know where a judge's head is at," he says. "At the end of the hearing, we felt we had a strong case that would prevail."

The FTC immediately asked the D.C. Circuit for an emergency injunction pending appeal. On Aug. 23, a three-judge panel -- David Tatel, David Sentelle, and Brett Kavanaugh -- unanimously denied the motion.

Five days later, Whole Foods closed its deal with Wild Oats. After all, four federal judges -- Friedman and the appellate panel -- all concluded the FTC didn't have much of a case.

'THE TIDE TURNED'

At this point, the FTC could justifiably have dropped the matter. It had, after all, received absolutely no encouragement from either court. But this is perhaps where an agency's personality kicks in. As the Justice Department Antitrust Division had backed off merger challenges during the waning years of President George W. Bush's administration, the FTC had aggressively ramped up its enforcement. Despite the setbacks against Whole Foods, the agency wasn't ready to give up.

"It was not a snap decision," Wales recalls. "We have limited resources. We can't and shouldn't appeal every case we lose." In the end, he says, they felt that Friedman gave short shrift to the evidence involving Mackey (which was essentially ignored in the decision) and that the standard invoked to grant a preliminary injunction was too high.

On appeal to the D.C. Circuit, still seeking that preliminary injunction, lawyers from the FTC General Counsel's Office took the lead. The argument was assigned to veteran litigator Marilyn Kerst. It was the last matter Kerst handled before retiring from the FTC last summer. Denis represented Whole Foods in his first-ever appellate argument.

The return engagement before the appeals court occurred on April 23, 2008. The panel of judges had changed -- Sentelle, who had recently become chief judge, was replaced by Janice Rogers Brown. Perhaps Brown's involvement should have raised warning flags. Although generally considered a conservative, she has a reputation for unpredictability and iconoclastic views.

The bombshell fell on July 29. Nearly a year after the merger had closed, after Whole Foods had already sold or shuttered numerous Wild Oats stores and devoted 200,000 hours to retraining employees, the D.C. Circuit, in a 1-1-1 decision, reversed the district court and remanded the case.

Denis was stunned. That Tatel, despite ruling against an emergency injunction the previous year, now backed the FTC's narrow market definition was not entirely unexpected, based on his line of questions at the hearing. But Brown, writing for the court, took a totally new tack. She focused on "core" Whole Foods customers -- the ones so wedded to the store that they would shop there even if the prices rose much higher. Such shoppers, she wrote, can be a recognizable submarket and "a proper subject of antitrust concern."

Denis says this issue of core customers was "not in the FTC briefs, not raised at oral argument. There was never any question in oral arguments that would have led anyone to believe that was what she was thinking. ... It's frustrating as an advocate to lose on the basis of an argument you didn't get to have."

In his dissent, Kavanaugh agreed, commenting that it is "not our usual role to gin up new arguments that the appellant did not make." He called the decision "a judicial about-face," writing, "[T]his Court got it right a year ago in refusing to enjoin the merger, and there is no basis for a changed result now."

He also took issue with the standard the court should apply when granting the FTC a preliminary injunction. "I do not believe that the law allows the FTC to just snap its fingers and block a merger," Kavanaugh wrote.

This standard is what many onlookers have zeroed in on as the most significant aspect of the D.C. Circuit's decision. Under Section 13(b) of the FTC Act, the agency can ask a district court to temporarily halt a merger it believes is anti-competitive, pending an administrative Part III trial on the merits. The FTC doesn't have to prove to the court that the merger is actually illegal. Agency lawyers just need to raise "serious, substantial, difficult, and doubtful" questions about the merits of the transaction that warrant review.

Just what "serious, substantial" means has been open to interpretation. Brown wrote that Section 13(b) incorporates a sliding scale that trades off the FTC's likelihood of success on the merits against the balance of the equities in temporarily stopping the deal. Noting that the equities "often weigh in favor of the FTC" (and because Friedman didn't even consider them), Brown concluded that the FTC is entitled to an injunction unless it has "entirely failed to show a likelihood of success." Says Denis, "I read this as meaning any non-zero probability of success is sufficient. If this was the law, the FTC could always or nearly always meet this test."

As for Wales, he says, "We were very, very pleased. We saw it as a tremendous victory for the FTC and the proper 13(b) standard. ... The tide turned when we got the court of appeals decision."

Still, FTC general counsel William Blumenthal -- who served from 2005 until January 2009, when he joined Clifford Chance -- recalls reminding jubilant agency lawyers right after the decision was issued, "We haven't yet won anything. All we got was a reset to a scoreless tie."

Whole Foods petitioned the court to rehear the case en banc, this time retaining one of the nation's most prominent appellate litigators, former Solicitor General Theodore Olson, a D.C. partner at Gibson, Dunn & Crutcher. Olson wrote that the decision would "turn antitrust law on its head" and give the FTC "unbridled authority to block

a merger." The court denied the petition on Nov. 21, in large part, Denis says, because Tatel slightly revised his opinion: Instead of concurring in Brown's opinion, he merely concurred in the judgment. Thus, Brown no longer delivered the "opinion of the court" -- just her own opinion. As the judges noted in denying an en banc hearing, no decision of the court meant no concern over inconsistency with prior decisions. "On one level, I admire what he did," Denis says. "On another level, I'm irritated."

YET ANOTHER TRIAL

About a week after the appellate decision, the FTC on Aug. 8 turned up the heat on Whole Foods by bringing the Part III administrative proceeding back to life. A Part III trial takes place before an FTC administrative law judge, with review by the five commissioners, which can then be appealed to a federal appellate court. In the long run, having this option does not guarantee the FTC a legal victory. But it does give the agency enormous power to drag out a merger challenge long beyond the point when it makes any business sense not to settle with regulators.

For the Whole Foods proceeding, the FTC named its own new, high-powered lawyer to help lead the charge: J. Robert "Robbie" Robertson, who had been a D.C. partner at Kirkland & Ellis before joining the FTC as chief trial counsel in the Bureau of Competition earlier that summer.

Trial was set for Feb. 16, 2009. (It was later pushed back to April 6.) Already in possession of millions of pages of documents, the FTC asked for more -- another 1.6 million pages of documents; 300 million records of weekly transaction prices; and 280 spreadsheets with detailed information about store sales, costs, and demographics in the 29 markets where the FTC said the merger threatened competition. Whole Foods was hard-pressed to handle the truncated discovery schedule, shelling out \$2 million to electronic discovery vendors alone.

Third-party witnesses were even more burdensome, with the company subpoenaing 96 competitors and suppliers around the country.

Whole Foods asked that the Part III trial be stayed until Friedman had a chance to re-examine the remanded case. But FTC lawyers saw no point in waiting. The transaction had been consummated, and any harm to consumers was ongoing. "We wanted to drive the case to resolution as quickly as possible. Every day that goes by made it harder to get meaningful relief," Wales says.

Faced with the possibility of several more years of time-consuming and expensive litigation, Whole Foods responded as usual: It hired more lawyers. The company retained Lanny Davis, a D.C. partner at Orrick, Herrington & Sutcliffe and former special counsel to President Bill Clinton, and W. Stephen Cannon, D.C. managing partner at Constantine Cannon, who had served on the Antitrust Modernization Commission. The commission in 2007 had recommended that Congress remove the FTC's authority to hold Part III trials. Whole Foods also hired lobbyists from Glover Park Group and Michael Torrey Associates to raise sympathy among lawmakers and to highlight the disparity between the FTC's antitrust powers and those of the Justice Department.

In the legal equivalent of a Hail Mary pass, Davis and Cannon sued the FTC in U.S. District Court for the District of Columbia on Whole Foods' behalf, claiming "denial of fundamental due process." The Dec. 8 complaint, which was without precedent, charged that the commissioners had prejudged the case, finding the merger was illegal even before the Part III trial began. They asked that the court terminate the Part III proceeding and restrict the antitrust review to federal court. The FTC moved to dismiss the complaint, which was subsequently withdrawn by Whole Foods in January of this year.

Asked his opinion of the lawsuit, Wales just laughs: "Obviously we didn't see any merit in it."

In a Dec. 9 press conference at the U.S. Capitol with Davis, Mackey's frustration was evident. "The whole thing is ridiculous. Everyone knows it's ridiculous," fumed the Whole Foods CEO. "They waited 12 months after the merger to begin the administrative law process," which he described as "a kangaroo court."

"It's about intimidation and bullying and getting us to make a settlement. It's an abuse of regulatory power," Mackey continued. "It's almost a vendetta."

Wales disputes this characterization. "We did not see it as a personal vendetta. That couldn't be further from the truth."

Estimating that the administrative case would cost Whole Foods another \$15 million to \$20 million in legal fees, Mackey revealed that Whole Foods had approached the FTC to discuss a settlement in September 2008. The two sides could not reach a deal. "It's very difficult to come to a just settlement when the other side has a gun to your head," he said. "We'd love to reach a settlement, but so far, we don't feel the FTC has been very reasonable. We're very far apart."

THE DEAL IS DONE

As the administrative trial date drew ever closer, Whole Foods went back to the FTC to try to end the case. The motivating factors, Denis says, were "the cost, the time and attention and distraction to management, and whether we could get a good deal." Just prior to the start of negotiations, Friedman scheduled a two-day hearing on the remand, complete with live witnesses, which Denis felt gave his side a leg up. "The FTC didn't want a real hearing," he asserts. "They had a very narrow view of the issues on remand, and we had a much broader one."

"We had great evidence that prices had gone up after the acquisition," Wales counters. "We were excited about getting back before Judge Friedman."

Nonetheless, the FTC commissioners agreed to put the Part III case on hold, and from late January until early March, the parties met regularly to hammer out a deal. Denis was accompanied by Whole Foods Executive Vice President Jim Sud, while the FTC was represented by Wales, Reilly, and Norman Armstrong. Both sides describe the meetings as intense but professional.

The settlement announced on March 6 calls for Whole Foods to sell 32 stores -- 13 currently operating stores and 19 stores that are now closed. The company must also divest Wild Oats intellectual property, including the rights to the Wild Oats brand. Responsibility for selling the assets belongs to the divestiture trustee, Food Partners LLC, and the stores may be sold off to multiple buyers. Whole Foods says it will incur a \$19 million non-cash charge as a result.

While the divestiture represents a significant portion of the Wild Oats assets, the FTC had been pushing to undo the entire deal. Settling meant Whole Foods is walking away with more than half a loaf (seven-grain whole wheat?).

Beyond the natural foods market, the legacy of this case has only begun to be written. Although it does not speak for the D.C. Circuit, Brown's opinion is carrying some weight as precedent. In the first post-Whole Foods case, U.S. District Judge Rosemary Collyer of the District of Columbia wrote that the evidence involving the merger of two companies that make software systems used to estimate the cost of auto repairs was "complicated and uncertain." But because the FTC raised sufficiently serious and substantial questions, she granted a preliminary injunction on March 9 -- and cited Brown's opinion repeatedly. Two days later the two companies, CCC Holdings and Mitchell International, decided to abandon their \$1.4 billion merger rather than face an FTC administrative trial, which had been set for March 31.

"This case may well show the future implications of the Whole Foods opinion," warns O'Melveny & Myers partner Richard Parker, who represented CCC. "The FTC won a key victory when they convinced Judge Collyer that the Whole Foods standard was significantly less than the standard of likelihood of success on the merits."

In the coming months, the FTC will have ample opportunity to flesh out the standard even more. "I can't tell you how many deals are currently in the [litigation] pipeline," Wales says. But the FTC has brought six new merger-related lawsuits in the past 12 months, an agency record. Four of those mergers were blocked, and two are still pending in court, adds Wales.

Noting that he is a Republican, Wales says, "This is not about ideology or politics. We just happen to have a lot of anti-competitive deals now. I don't have any second thoughts about any of our enforcement decisions."

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