Product Markets in Merger Cases: The *Whole Foods* Decision

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The definition of the relevant market is often the dispositive issue in antitrust merger cases. If the market is defined narrowly, the market shares of the merging parties are often sufficient to make a prima facie showing[1] that the merger violates the antitrust laws. If the market is defined broadly such that the market shares of the merging entities are much smaller, then it is unlikely that the merger will be found unlawful. A decade ago, in *FTC v. Staples, Inc.*,[2] the Federal Trade Commission convinced the U.S. District Court for the District of Columbia that "office supply superstores" constituted a market separate from other mass merchandisers selling identical office supplies and had the merger of Staples and Office Depot enjoined because it substantially increased concentration in what was essentially a three firm market.

This summer the FTC made similar market definition assertions in its challenge to the proposed acquisition of Wild Oats Markets, Inc. by Whole Foods Market, Inc.[3] The FTC contended that Wild Oats and Whole Foods were part of a "premium natural and organic supermarkets" distinct from traditional supermarkets. It asserted that conventional supermarkets do not constrain premium natural and organic supermarkets (PNOS) in nearly the same way that Whole Foods and Wild Oats constrain one another. The FTC cited various attributes of Whole Foods and Wild Oats—that they maintain a unique inventory of products focused mainly on natural and organic products, describe themselves as "Lifestyle Retailers" offering superior service, and cater to distinct customers who are educated and affluent and interested in lifestyle issues[4]—which distinguished them from conventional supermarkets. The FTC also relied on various statements by John Mackey, the Whole Foods CEO, such as that "Safeway and other conventional retailers . . . can't really effectively focus on Whole Foods Core Customers without abandoning 90 percent of their own customers,"[5] as supporting its PNOS market definition. Since the merging parties were by far the two largest players in this proposed PNOS market, the concentration statistics alone would have made a prima facie showing that the acquisition violates the antitrust laws.[6]

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1 United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 363–65 (1963) (merger that produces a firm controlling an undue percentage share of the relevant market raises an inference that the effect of the contemplated merger is to substantially lessen competition).

2 970 F. Supp. 1066 (D.D.C. 1997).

3 FTC v. Whole Foods Market, Inc., Case No. 07-01021-PLF (D.D.C. filed June 6, 2007), *available at* http://www.ftc.gov/os/caselist/0710114/070605complaint.pdf.

4 FTC Corrected Brief on Its Motion for Preliminary Injunction (Public Version) at 29–47 [FTC Brief], *available at* http://www.ftc.gov/os/caselist/0710114/080107corbrief.pdf.

5 *Id.* at 4.

6 *Id.* at 49–51. Apart from Whole Foods and Wild Oats, the only other PNOS identified by the FTC were Earth Fare in southeastern states and New Seasons in Oregon.

In a ninety-three-page opinion, however, the U.S. District Court for the District of Columbia rejected the FTC's proposed market definition and denied its motion to enjoin the acquisition. *FTC v. Whole Foods, Inc.*, 2007 U.S. Dist. LEXIS 61331 (D.D.C. Aug. 16, 2007) [Opinion]. Based largely on testimony and studies from the defendants' experts, the court found that conventional stores such as Safeway, Delhaize America, Kroger's, and others had "repositioned" themselves to offer more natural and organic products and would operate to constrain Whole Foods in the post-merger market. It found that grocery shoppers are price sensitive and frequently engage in "cross-shopping," i.e., buying various grocery items from different stores in their local areas, and purchasing many, if not the majority, of their items at conventional stores. Opinion at *25, *39. Internal, ordinary course documents from Whole Foods also showed that it conducts price checks at conventional stores and has the same prices in areas where there is no Wild Oats store as those areas in which there is a Wild Oats store. As to the unique attributes of PNOS raised by the FTC, the court found they were simply a way to differentiate these stores from their competitors, rather than a basis to conclude there is a separate PNOS market. Opinion at *26. The court's opinion did not mention or discuss Mr. Mackey's comments, whether on market definition issues or any other subject.[7] The failure of the trial court to do so was cited as error "No. 1(a)" by the FTC in its motion filed with the Court of Appeals for the District of Columbia Circuit asking it to enjoin the merger pending resolution of the appeal.[8] The court of appeals denied the Commission's motion on August 23, 2007.[9]

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Whole Foods does not break any new ground in terms of legal doctrine, and largely applies settled legal principles to the facts at issue. Nonetheless, several aspects of its opinion will bear on future merger cases. These include:

- the centrality of pricing evidence—which is perhaps the main feature that distinguishes *Whole Foods* from *Staples*;
- the weight courts give (or will not give) to executives' comments, even when relevant and notorious,[10]
- the focus a court will give to "marginal," rather than "core," customers to determine whether customers would switch to conventional stores in the event of a price increase; and
- Distinguishing what is simply marketing differentiation from a truly "separate" market or submarket—or put differently, the proper role of *Brown Shoe*'s "practical indicia" in merger analysis.[11]

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[7] FTC Brief, *supra* note 4, at 1–2. Mr. Mackey also made a number of statements cited by the FTC as indicating the acquisition was anti-competitive including one that it would allow Whole Foods to avoid "nasty price wars."

[8] FTC v. Whole Foods Market, Inc., D.C. Cir. No. 07-5276, Memorandum of Points and Authorities in Support of Plaintiffs Motion for an Injunction Pending Appeal 2 (Aug. 17, 2007), *available at* http://www.ftc.gov/os/caselist/0710114/0710114injpendpub.pdf.

[9] The court of appeals initially had issued an administrative injunction enjoining the acquisition on August 20, 2007, and directed appellees to file a supplemental brief addressing the eight reversible errors identified by the FTC in its filing. After this response was filed, however, the court of appeals vacated the administrative injunction and denied the FTC's motion in an order dated August 23, 2007, *available at* http://www.ftc.gov/os/caselist/0710114/070823wholefoodsorddenyinjuncpendappl.pdf. That order stated that, although the FTC has raised some questions about the district court's decision, it had not made a strong showing of likelihood of success, in that it had failed "at this stage" to carry its burden to show that the court's findings were clearly erroneous and there were errors of law.

[10] Holman Jenkins, *Business World: Whole Food Fight*, Wall St. J., June 27, 2007, at 12.

[11] United States v. Brown Shoe Co., 370 U.S. 294 (1962).

Defining Product Markets

The requirement to define a product market in merger cases derives from Section 7 of the Clayton Act[12] barring mergers which may tend to create a monopoly or substantially lessen competition in any "line of commerce" (product market) in "any section of the country" (geographic market). More than forty years ago, in *Brown Shoe v. United States*, the Supreme Court stated that "[T]he 'outer boundaries'" of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it."[13] Within this broader market, said the Court, there may also be "well-defined submarkets" which themselves constitute product markets for antitrust purposes.[14] Such markets may be determined by examining certain "practical indicia," such as "industry or public recognition of the submarket 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." Applying these principles to the case before it, the Court held that men's, women's, and children's shoes were separate markets, but rejected "finer" markets based on further age/sex distinctions. It thus became apparent early on that market definition issues would be very fact-specific. Important factors would include economic testimony regarding cross-elasticity of demand and real-world evidence about how the merging parties view their own market position and competition.

The submarket criteria from *Brown Shoe* initially caused some courts to find submarkets to exist within broader relevant markets or find separate markets based on the *Brown Shoe* criteria alone, without analyzing cross-elasticity of demand issues.[15] In recent years, however, courts have increasingly recognized that, as stated by the *Brown Shoe* Court itself, these criteria are simply "practical indicia" to be used as part of the analysis of substitutability and cross-elasticity of demand issues.[16]

The DOJ/FTC Horizontal Merger Guidelines[17] do not specifically mention submarkets. They focus, instead, on how customers will respond to price increases. The Merger Guidelines provide that the agencies' merger analysis should begin with each product sold by each merging firm and ask what would happen if a hypothetical monopolist imposed a "small but significant and nontransitory increase in price" (SSNIP).[18] If, in response to that price increase, the reduction in sales would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase, then the agency will add to the product group the product that is the next best substitute. This process is repeated until the appropriate group of products has been identified. The Merger Guidelines state that the SSNIP will normally be 5 percent but may be less

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[12] 15 U.S.C. § 18.

[13] 370 U.S. at 325.

[14] *Id.*

[15] *See* ABA Section of Antitrust Law, Antitrust Law Developments 378–80 (6th ed. 2007). The Supreme Court has not addressed merger issues since *United States v. General Dynamics*, 415 U.S. 486 (1974).

[16] H.J. Inc v. ITT, 867 F.2d. 1531, 1540 (8th Cir. 1989); Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210 (D.C. Cir. 1986); FTC v. Arch Coal, Inc., 329 F. Supp. 2d. 109, 119–20 (D.D.C. 2004); United States v. Oracle, Inc., 331 F. Supp. 2d. 1098, 1119 (N.D. Cal. 2004).

[17] U.S. Dep't of Justice and Fed. Trade Comm'n, 1992 Horizontal Merger Guidelines (1992, rev. 1997), *available at* http://www.ftc.gov/bc/docs/horizmer.shtm [Merger Guidelines].

[18] *Id.* § 1.11 "Product Market Definition." The SSNIP test has been criticized as impractical in that there would never be adequate data to make such calculations. Robert G. Harris & Thomas M. Jorde, *Market Definition in the Merger Guidelines: Implications for Antitrust Enforcement*, 71 Cal. L. Rev. 464, 481 (1983).

in some markets. Many courts apply the SSNIP test from the Merger Guidelines to determine the relevant product market in merger cases.[19]

Retail Product Market Definition and the Road to *Whole Foods*

Decisions prior to *Staples* involving grocery store mergers or issues similar to *Whole Foods* reached varying conclusions as to the appropriate product market, some with little or no analysis. In *California v. American Stores Co.*,[20] which involved a merger of two grocery supermarket chains, the lower court defined the market as full-line grocery stores with more than 10,000 square feet. It specifically excluded "mom and pop" stores, convenience stores and non-grocery stores, such as department stores, service stations, and drug stores. This was based on evidence that the merging parties themselves, as well as shoppers, did not view them as competition.[21] In contrast, in *Thurman Industries, Inc. v. Pay 'N Pak Stores, Inc.*,[22] the Ninth Circuit concluded that home centers were not a separate market from specialty retail stores with more limited, but similar, product offerings. According to the Ninth Circuit, the defendant presented "overwhelming evidence" that for any given product sold at a home center, the identical product is also available for purchase at several specialty stores and there is significant consumer sensitivity to price fluctuations.[23] While several of the *Brown Shoe* indicia pointed to home centers as a submarket, such indicia were inadequate to offset the fact that price reductions by specialty stores would lure customers from home centers.[24] *Bon-Ton Stores, Inc. v. May Department Stores Co.*[25] found, based on the *Brown Shoe* "qualitative" indicia and internal company documents, that "traditional department stores" were a separate market from a marketplace encompassing retailers in general.

In *FTC v. Staples, Inc.*, the court found the FTC made a "compelling showing" that a small but significant increase in Staples' prices would not cause a significant number of consumers to turn to non-superstore alternatives to purchase consumable office supplies. This evidence consisted of showing that Staples' prices in the geographic markets where it is the only office superstore were 13 percent higher than those markets in which it had competition from Office Depot or OfficeMax. Likewise, Office Depot prices were "well over" 5 percent higher in markets where it had no competition from other office superstores. The logical conclusion from such evidence was that consumers did not switch to Wal-Mart, Target, or Best Buy or other non-office superstore alternatives when prices were increased. Other evidence showed that Staples or Office Depot do lower their prices when faced with entry by another office superstore, but not other retailers. This pricing evidence was supported by the *Brown Shoe* "practical indicia," such as distinct customers and industry or public recognition of the submarket as a separate economic entity. The court itself made trips to the stores from which it concluded that office superstores are in fact "very different

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[19] *Arch Coal*, 329 F. Supp. 2d at 120; *Oracle*, 331 F. Supp. 2d at 1111–12; United States v. SunGard Data Sys., 172 F. Supp. 2d 172, 190 (D.D.C. 2001).

[20] 697 F. Supp. 1125 (C.D. Cal. 1988), *affd in part and rev'd in part on other grounds* 872 F.2d 837 (9th Cir. 1989) *rev'd on other grounds* 495 U.S. 271 (1990).

[21] *Id.* at 1129. In its decision in *American Stores*, the Ninth Circuit stated that, were it to independently review the product market definition, it may reach a different conclusion than the lower court. 872 F. 2d at 841.

[22] 875 F.2d. 1369 (9th Cir. 1989).

[23] *Id.* at 1374.

[24] *Id.* at 1376.

[25] 881 F. Supp. 860 (W.D.N.Y. 1994). *See also* Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979) (relevant market was drive-thru photo processing based in customer perception of greater convenience and service than walk in stores).

in appearance, physical size, format . . . etc." Likewise, internal documents of defendants showed that they focused mainly on competition from other office superstores and used the phrase "office superstore industry" in strategic planning documents.[26]

Building on *Staples*, the FTC challenged Whole Foods' acquisition of Wild Oats on the grounds that, since Whole Foods and Wild Oats were close substitutes in various local markets, their merger would facilitate unilateral price increases. Indeed, the FTC's brief in support of the injunction argued that Whole Foods decided to acquire Wild Oats only after concluding that its "systematic destruction" through competition would require too much time, expense, and uncertainty. Whole Foods planned to close thirty Wild Oats stores after the acquisition, and the purchase price included a premium to take Wild Oats off the table for other potential purchasers. According to material cited by the FTC, Whole Foods' CEO Mackey told his Board that buying Wild Oats would avoid "nasty price wars"[27] in several areas and forever eliminate the possibility of Kroger's or Safeway using their brand value to launch a competing natural/organic chain.

The FTC's product market evidence in *Whole Foods* focused mainly on such statements and internal documents. Unlike *Staples*, however, the FTC did not offer evidence that PNOS stores had higher prices in areas with no competitive overlap, but instead pointed to evidence that Whole Foods' margins were lower in markets when there was a Wild Oats.[28] The pricing evidence offered by the FTC's expert focused on the effect that entry by PNOS stores have on the sales and operating margins of defendants.[29] It showed that entry by Whole Foods near a Wild Oats had a greater negative effect on Wild Oats than entry by other stores.[30] There were apparently no Wild Oats entries in Whole Foods areas.[31] The FTC also emphasized that PNOS stores have much higher operating margins than conventional stores, and thus their customers must be insensitive to price increases.[32]

The Trial Court's Ruling in *Whole Foods*

The district court opinion focused mainly on the ability of conventional stores to constrain the pricing of the post-merger Whole Foods. Relying principally on the testimony of the defendant's experts, particularly economist David T. Scheffman, the court found that Whole Foods would not be able to sustain a price increase in a properly defined product market.[33] In getting there, the trial court accepted Dr. Scheffman's view that the SSNIP/hypothetical monopolist test under the Merger Guidelines focused on marginal consumers. Opinion at 15. Marginal consumers, according to Dr. Scheffman, could switch in response to a SSNIP in any one of three ways—by reducing their purchases at one store and substituting another, by switching a shopping trip from one market to

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26 FTC v. Staples, Inc., 970 F. Supp. 1066, 1078–79 (D.D.C. 1997).

27 FTC Brief, *supra* note 4, at 1. The public versions of the briefs of both parties redact some evidentiary material, such as the volume of sales Whole Foods expected to obtain from Wild Oats stores to be closed after the acquisition.

28 *Id.* at 22–24.

29 *Id.* at 26.

30 *Id.* at 26–29.

31 *Id.* at 22–28.

32 *Id.* at 21.

33 In addition to Dr. Scheffman, Whole Foods also provided testimony and studies from a "food marketing" expert, Dr. John L. Stanton, which focused on store formats and operations of numerous conventional grocery store chains, and Ms. Kellyanne Conway, a polling expert who conducted survey to support Dr. Scheffman's report. Based on testimony by an FTC expert that Ms. Conway's survey was flawed, the court gave it no weight or consideration. Opinion, FTC v. Whole Foods, Inc., 2007 U.S. Dist. LEXIS 61331 at *10–*11 (Aug. 16, 2007).

another, or simply by changing retailers. According to Dr. Scheffman, supermarkets make their pricing, quality and service decisions in ways designed to attract these marginal consumers, and cannot survive by catering solely to core customers. Scheffman performed a Critical Loss Analysis[34] using both a 5 percent and 1 percent SSNIP, and concluded that actual loss would substantially exceed critical loss at either level of price increase. Opinion at 16–17. Since there was no evidence in the record to determine cross-elasticity of demand between PNOS and conventional stores, Dr. Scheffman based his critical loss analysis on market studies he reviewed, showing: (1) grocery shoppers are price sensitive; (2) Whole Foods and Wild Oats customers shift purchases between PNOS and other supermarkets and can do so "costlessly"; (3) most Whole Foods and Wild Oats shoppers frequently shop at other grocery stores; (4) other supermarkets compete vigorously for Whole Foods and Wild Oats customers; and (5) Whole Foods (and Wild Oats to a lesser degree) regularly price check other supermarkets to gauge their pricing and product assortments. Opinion at *17.

Other data from Dr. Scheffman showed that, when Whole Foods opened a store in a new local area, it captured substantial sales from local conventional supermarkets. *Id.* at 18. The court found this persuasive. While the study by the FTC expert showed that entry by Whole Foods into an area where a Wild Oats store already existed reduced the Wild Oats sales more than the conventional ones, "[t]he Court is unwilling to accept the assumption that effects of 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." *Id.* at *19. The court then summarized the "credible evidence" regarding the marketplace as follows:

> The problem is that "what's going on in the marketplace," according to the credible evidence before the Court, is that (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 of its stores in a region, regardless of whether there is a Wild Oats store nearby, and (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 Furthermore, the market studies and other evidence show that Whole Foods competes vigorously with other supermarkets to retain the business of its many marginal customers.

Id. at *20.

Dr. Scheffman's studies also showed that Whole Foods and Wild Oats shoppers frequently shop at conventional markets, and purchase the majority of natural and organic products sold in the United States from conventional rather than PNOS markets. *Id.* at *26–*27. According to the court, such "cross-shopping" shows that the "fundamental problem" with the FTC's product market is that post-merger many customers could and would shift their purchases of natural and organic foods to conventional markets if Whole Foods increased prices. Finally, Whole Foods internally projected retaining only one-third of Wild Oats' volume of business after the merger, with two-thirds going elsewhere. Quoting defense counsel, the court asked, if two-thirds of the volume was expected to go elsewhere, then "what kind of monopoly is this?" *Id.* at *31.

The district court also rejected the FTC's "product differentiation" argument, relying on another defense witness, Dr. John L. Stanton, a food marketing expert. Differentiation, said the court, is the primary method a supermaket uses to lure customers, and it can include such things as low prices, ethnic appeal, and any number of other steps stores may take to stand out. While a typi-

34 "Critical loss" is the point at which lost sales would wipe out any gains from a price increase. *Id.* at *16; Tenet Healthcare v. FTC, 186 F. 3d 1045, 1050 (8th Cir. 1999).

cal Whole Foods store is mission-driven, with an emphasis on a healthy lifestyle and environmental responsibility, it also carries all the "traditional categories" of products associated with supermarkets. *Id.* at *21. As the demand for natural and organic products has skyrocketed in recent years, conventional supermarkets are refocusing and repositioning their formats to offer an increased selection of natural and organic foods. *Id.* at *22–*23. The court concluded that the FTC's differentiation argument does not really address the key issue on market definition, which is "would customers switch" in response to a price increase, but simply reflects the different ways stores choose to compete with one another. *Id.* at *23.

Impact of *Whole Foods* on Product Market Issues

The *Whole Foods* opinion is necessarily fact-specific and in that sense has little impact on product market jurisprudence. The court's emphasis on objective data, through the SSNIP analysis and otherwise, is also consistent with recent trends in merger decisions. Three aspects of the *Whole Foods* opinion still stand out.

The Elephant in the Room—CEO Mackey's Remarks. The court did not discuss the statements made by Whole Foods' CEO John Mackey, and what they showed as to Whole Foods' subjective intentions. Prior to and during this merger litigation, Mackey made a number of comments from which it could be inferred that his company's acquisition of Wild Oats was anticompetitive and/or that the PNOS market suggested by the FTC was correct.[35] Such comments included ones that buying Wild Oats would eliminate a competitor, prevent "price wars," end "forever, or almost forever" the possibility of the conventional stores like Safeway buying an existing chain to compete with Whole Foods, and that such conventional stores would never abandon their customer base to compete in the PNOS market.

In one sense the court's silence concerning the statements is surprising. The statements were a major focus of the FTC's case, and statements by senior executives as to the nature of the market and competition are relevant in merger cases under the *Brown Shoe* "industry and public recognition" indicia and otherwise.[36] Nonetheless, such evidence is seldom dispositive on its own: as described by Judge Easterbrook in *A.A. Poultry Farms v. Rose Acre Farms*[37] such comments may merely reflect " . . . a desire to extinguish one's rivals . . . entirely consistent with, often the motive behind, competition."[38] Their evidentiary value is especially weak if inconsistent with more objective, economic evidence.

In *United States v. Oracle, Inc.*,[39] for example, the government cited internal documents of Oracle and PeopleSoft stating they were each other's "closest competitors," and an Oracle doc-

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[35] FTC Brief, *supra* note 4, at 1–2. In addition to ordinary course documents like presentations to his Board of Directors, Mackey had a blog on the Whole Foods Web site and also posted comments on Internet sites under such pseudonyms as Rahodeb (an anagram of his wife's first name).

[36] United States v. Hammermill Paper Co., 429 F. Supp. 1271, 1287 n. 48 (W.D. Penn. 1977) 4A Phillip Areeda & Herbert Hovenkamp, Antitrust Law § 964(c) (2d ed. 2002) (stating that intent evidence in a merger case may be probative in determining whether the market has been defined too broadly); John Harkrider, *Proving Anticompetitive Impact: Moving Past Merger Guidelines Presumptions*, 2005 Colum. Bus. L. Rev. 317, 334 (2005) (stating that "great weight" should be given to evidence reflecting the views of senior management about the transaction). Item 4(c) of the HSR Report form specifically seeks documents prepared by and for the purpose of analyzing the acquisition with respect to markets, market shares and competition, and these are often quite important in analyzing the competitive effect of a merger.

[37] 881 F.2d 1396 (7th Cir. 1989).

[38] *Id.* at 1402.

[39] 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

ument stating that "PeopleSoft" is our "Number 1 competitor." The court, however, found such evidence to be inconsistent with other evidence and discounted it.[40] Judge Vaughn Walker in *Oracle* also found the customer testimony on the product market issue "unhelpful."[41] It is only when, as in *Staples* itself, markets described in public statements of senior executives or internal planning documents are consistent with economic facts, that they form the basis of market definition.

Either way, the court's failure to address Mackey's comments shows how little weight will be given such evidence.

Core vs. Marginal Customers. The second issue is how (or with respect to which customers) to measure SSNIPs under the Merger Guidelines. The FTC argued that the SSNIP analysis should be made with respect to "core" customers, who are not price sensitive and have decided that natural and organic is important. It criticized Dr. Scheffman's Critical Loss Analysis for focusing mainly on marginal customers. The Court rejected this argument due in large part to the heavy degree of cross-shopping, i.e., most Whole Foods customers buy a majority of their items at conventional stores, already frequent the store(s) to which they would switch in the event of a price increase, and those conventional stores already sell over 60 percent of the natural and organic items sold. In essence, it concluded there were many more marginal than core customers, and the market definition issue should focus on this larger group.

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Section 1.11 of the Merger Guidelines relating to the general standards for product market definition does not specify whether to focus on core or marginal buyers. It simply states that the issue is whether "buyers" will shift their purchases to another product in the event of a price increase. In *United States v. SunGard Data Systems*,[42] the court discussed this issue in the context of a merger of computer disaster recovery services. It described the critical question under the Merger Guidelines as being whether the hypothetical monopolist can profitably raise price, and "there must be a significant number of customers that will not switch to a substitute product in response to a SSNIP . . . ."[43] The *SunGard* court states that this "significant" or "substantial" group of customers should be one that is "representative" of the entire client base for the product.[44] The *SunGard* court then goes on to conclude that, even though some segments of customers either could not or would not switch among various computer disaster recovery systems, it could not conclude that the sampling was either large enough or representative enough such that the narrow market sought by the FTC was appropriate under the SSNIP analysis.

The SSNIP analysis probably will not work to define a product market accurately if limited to either core or marginal customers. Core customers almost by definition will not switch, producing

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[40] *Id.* at 1165–67.

[41] *Id.* at 1131. The *Oracle* court also stated that customer preferences should not make a market, and the issue is not what customers like or prefer, but what they could do if the merged firm raised prices. *Id.* at 1131–35.

[42] 172 F. Supp. 2d 172 (D.D.C. 2001).

[43] *Id.* at 190; FTC v. R.R. Donnelley & Sons Co., 1990-2 Trade Cas. (CCH) ¶ 69,239 (D.D.C. 1990) (stating that customer testimony from isolated segments of market do not make for a separate product market). *See also* FTC v. Arch Coal, 329 F. Supp. 2d. (D.D.C. 2004), 109, 119–20 (stating that a "considerable number" of customers should switch if there is a SSNIP for the products to be in the same market).

[44] 172 F. Supp. at 190–92. FTC v. Cardinal Health, Inc., 12 F. Supp. 2d. 34, 48–50 (D.D.C. 1998) (prescription drug wholesalers are separate product market even though some customers could perform this service themselves since "majority" do not); Malcolm B. Coate & Armando E. Rodriguez, *Pitfalls in Merger Analysis: The Dirty Dozen*, 30 N.M.L. Rev. 227, 235 (2000) (stating that the fact that a majority of customers will not switch is generally not relevant as long as a sufficient number of customers will switch in the event of a price increase).

an unrealistically narrow market.[45] Conversely, a focus on marginal customers will expand the market and distort the competitive impact of the merger. The issue is not really whether customers are core or marginal, but whether enough customers would switch in response to a SSNIP.

In *Whole Foods*, however, the marginal customer was also the "representative" customer. According to the evidence deemed persuasive by the trial court, most customers who shop at Whole Foods or Wild Oats also shop at a conventional store and are buying an increasing amount of natural and organic items from those stores. The FTC is likely correct to assert there is a core customer who insists on buying natural and organic items exclusively at a Wild Oats or Whole Foods store—the "affluent lifestyle "customer identified by the FTC. It was not, however, proper to use such customers for the SSNIP analysis here, or other analyses measuring customer response to price increases. Such customers comprise a small minority of PNOS shoppers, and their affluence alone makes them unresponsive to price increases such that they have little need for the protections of the antitrust laws.

Differentiation as a Basis for a Product Market. The third interesting aspect of the opinion in *Whole Foods* is what it teaches about *Brown Shoe*'s "practical indicia." The *Whole Foods* court concluded that the unique aspects of PNOS upon which the FTC relied as a basis for a separate market were in fact just marketing strategies. Some of the facts cited by the FTC, however, such as size and format of stores, and the greater variety of premium and natural SKUs, were cited by the *Staples* court[46] as a basis for the separate office superstore market. They are in the *Brown Shoe* "laundry list" of factors to consider in determining submarkets. Some courts have found separate product markets based on the quality and features of the products,[47] but other courts shy away from separate markets based on subjective differentiation facts alone.[48] The basic message from the *Whole Foods* decision is that the non-economic *Brown Shoe* criteria cannot be the basis for a separate market where the pricing evidence shows that customers will likely switch to other products in the event of a price increase.

In order to determine the proper role for the *Brown Shoe* submarket practical indicia in defining product markets, it is necessary to recognize that such indicia fall into three broad categories. The first category includes those for distinct prices, sensitivity to price changes, and distinct customers. These indicia would be subsumed in any cross-elasticity analysis, including the SSNIP test from the Merger Guidelines. The second category includes unique production facilities and specialized vendors. As in *Whole Foods*, these indicia simply will not be present in many cases. The third category includes industry and public recognition of the proposed market as a separate economic entity and the product's peculiar characteristics and uses. These factors are essentially non-economic in nature and should not be used to create a separate market unless that market is also consistent with the economic data. Standing alone they are, as the *Whole Foods* opinion notes, simply marketing strategies.

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45 A "core" customer analysis was used in Bon-Ton Stores, Inc. v. May Dep't Stores, 881 F. Supp. 860, 824 (W.D.N.Y. 1994), to conclude that department stores were a separate market. The core customer was one who tends to shop exclusively for women's clothes at department stores.

46 FTC v. Staples, Inc., 970 F. Supp. 1066,1078 (D.D.C. 1997).

47 United States v. Gillette Co., 828 F. Supp. 78 (D.D.C. 1993) (premium writing instruments is separate market).

48 H.J. Inc. v. ITT, 867 F.2d 1531, 1539 (8th Cir. 1989); *In re* Super Premium Ice Cream Distribution Antitrust Litig., 691 F. Supp. 1262, 1268 (N.D. Cal. 1988) (all grades of ice cream compete against one another and plaintiffs failed to show that differences, such as physical or price, have any antitrust significance).

The logical way to define the product market in antitrust cases is, as recognized by many courts, essentially a three-step process. The first step is to limit the market to sellers or producers that have functionally interchangeable products. The next step is the analysis of how consumers would react to a price increase. This is where the "rubber meets the road" most often. In *Staples*, consumers did not flee to Target or Wal-Mart for their pens and pencils even though Staples and Office Depot had higher prices for those items. The third step in the analysis is examination of the non-economic *Brown Shoe* indicia, such as peculiar characteristics and industry recognition.

In *Whole Foods*, defendants convinced the court that, due to the substantial overlap in customers between conventional and PNOS, customers would, and already do, switch to conventionals if Whole Foods raised its prices. On the non-economic factors, the court found the evidence at least mixed or favoring the defendants, for example the evidence that many conventional stores had also switched to the "lifestyle" mode, and the industry recognition factor was blurring. As such, it was able to easily discount the *Brown Shoe* non-economic factors and characterize them as simply marketing strategies rather than a basis for a separate market.

Apart from the facts of *Whole Foods*, non-economic indicia should seldom result in a separate market where there is functional interchangeability and cross-elasticity of demand. This would distort the competitive analysis away from the fundamental consumer welfare paradigm and focus on issues unrelated to whether the merger at issue promotes or impedes competition. Where consumers could and would switch to good substitutes in the event of a price increase, the fact that the industry may characterize a market as separate, or the products in it as having "peculiar" uses, should not be used to create a separate market.

Conclusion

The basic problem with the FTC's position in *Whole Foods* was that it lacked the pricing evidence it had in *Staples*, which showed that customers did not go elsewhere if the office superstores increased their prices. *Whole Foods* is an attempt by the FTC to persuade a court that if you take a CEO's statements about a merger and stir it in with evidence showing the existence of several "practical indicia" from *Brown Shoe*, the resulting mixture should trump objective evidence about how customers would react in the event of a price increase. It was not successful, and the court's decision underscores the dominant influence of economic evidence in merger cases today. ●