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FTC Records Two Wins as Staples-Office Depot Merger Abandoned for a Second Time

On May 10, Staples and Office Depot announced that they would be terminating their \$6.3 billion merger in the wake of a federal judge's decision to issue a preliminary injunction blocking the deal. This represents the second time in less than two decades that the companies abandoned their plans after the FTC raised antitrust concerns, successfully halting their attempt to consolidate.

Under the terms of the merger agreement, Staples will pay a \$250 million break fee to Office Depot.

Background

Staples had announced plans to acquire Office Depot on September 4, 1996, but terminated the proposal less than a year later after a federal judge granted the FTC's request for a preliminary injunction on June 30, 1997. The FTC argued in that case that the proposed transaction would have combined two of the three leading office superstore chains, substantially lessening competition in the retail sale of consumable office supplies.

On February 4, 2015, the companies announced their second attempt at a merger and on December 7, 2015, the FTC filed a complaint in federal court seeking injunctive relief against the proposed transaction, this time alleging that it would have created a dominant firm in the provision of consumable office supplies to large B2B (business-to-business) customers in the United States.

To assuage the FTC's concerns, the parties offered to divest supply contracts worth \$500 million—and later tried to revise the offer to \$1.25 billion—but the agency neither accepted the parties' concessions nor responded with a counteroffer.

Market Definition

The government's case in chief lasted more than two weeks and included testimony from an economist and a number of third-party witnesses. Throughout the hearing, the FTC's delineation of the relevant product market was repeatedly put into question by both the defense and the judge, who at times expressed open skepticism about the agency's approach to market definition.

The FTC maintained that "consumable office supplies" included items like pens and paper, but excluded ink and toner for printers and copiers because ink and toner manufacturers serve many large B2B customers directly through "managed print services" (under which ink and toner sales are bundled together with toner and copier leases and related maintenance services), and thus these products warranted separate consideration. The defendants argued that the agency's deliberate exclusion of products from the market definition both artificially inflated the parties' market shares and contradicted the FTC's earlier-issued statement when it approved the Office

Depot-OfficeMax merger in 2013 and took the position that ink and toner were part of the relevant market at the time.

The FTC's market was also limited to certain large customers. It contended that Staples and Office Depot were "the best options for most large [B2B] customers—and the only meaningful options for some large [B2B] customers—particularly those with facilities in multiple regions of the country." The government has previously been victorious in defining a national product market around a particular subset of customers, including most recently in 2015 when it succeeded in blocking Sysco's proposed acquisition of US Foods. Staples and Office Depot, however, challenged the FTC's use of the Fortune 100 as a proxy for large office supply customers, accusing the regulator of "gerrymandering" by excluding hundreds of large B2B customers from its calculations of the market.

Defining the market as it did, the FTC alleged that the merged entity would control as much as 80% of the market post-transaction. Case law did not require an exact market definition, the government claimed, and its estimated calculation satisfied the presumption of harm under the merger guidelines.

New and Existing Competition

The FTC's complaint expressly excluded from the market other office supply vendors, including Amazon and regional players such as W.B. Mason, alleging that they would not be viable competitors to a combined Staples-Office Depot for large B2B customers. To this end, the government relied, in part, on the merging parties' own documents, some of which suggested that they were each other's only or closest competitors. Staples' internal documents showed, for example, that "[t]here are only two real choices for customers," and Office Depot documented to a customer that, "[o]n a national scale, Office Depot's competition is Staples."

The defendants asserted that they compete vigorously against a number of players, including Amazon and W.B. Mason, and referred again to the FTC's prior statement in Office Depot-OfficeMax, where the regulator had found online and regional players to be growing in both number and strength. A W.B. Mason executive testified that the company did not have the ability to compete with Staples and Office Depot for national B2B accounts and that it recently abandoned a plan to expand nationally. Large B2B customers testified that regional players, including W.B. Mason, do not typically bid for or win large B2B contracts.

Staples and Office Depot argued that a part of the rationale behind their proposed transaction was to be able to better compete against Amazon Business (the online retailer's office supply division, which entered the market in 2015), which they presented as a rapidly expanding competitor that would constrain any anticompetitive price increase post-merger. The key question was whether Amazon Business would restore lost competition in a timely and sufficient manner. The FTC argued that Amazon Business would have to become a competitive threat in two to three years and its expert witness raised doubts about Amazon Business' likely ability to compete for large B2B customers in that time frame.

Spoon-Feeding Witnesses

During the FTC's investigation of a deal, it calls on third parties, including customers and competitors of the merging companies, to seek their views on the proposed transaction. If those discussions favor the FTC, the agency's tried-and-true practice has been to convert such oral discussions into written declarations. The FTC typically drafts the language of the declaration, which it then sends back to the witness for review and comment.

These declarations ultimately provide the basis of the FTC's complaint and are commonly used as a way to submit factual evidence in the FTC's motion for a preliminary injunction.

The FTC followed this same practice in its case against Staples-Office Depot. Among the government's witnesses was an Amazon Business executive, who refused to approve a declaration that the FTC had drafted. The judge expressed concern about the FTC's handling of witness declarations, questioning whether the declarations were truly the witnesses' words or whether the government had "spoon-feed" testimony to witnesses. The FTC had never been questioned by a court on this litigation practice prior to this case.

The Best Defense May Be No Defense?

Following the government's case, in a surprising and unprecedented move, the defendants declined to call any witnesses in their defense. Having observed the judge's hesitations and extensive questioning of the government's witnesses throughout, some suspected the merging parties may have had a great deal of confidence in where they stood by that point. More importantly, however, they had spent the entire hearing challenging every aspect of the FTC's case, and undercutting its witness and expert testimony, and in their bold move denied the government the reciprocal ability to cross-examine Staples and Office Depot executives. Had they subjected their own witnesses to cross-examination, the parties likely would have been faced with their "bad" documents and risked giving the government the opportunity to resuscitate some of its case. Although any bad documents would have been included in the documentary record that the judge considered in making his decision, they likely did not carry the same weight that they might have had they been argued in open court. Failing to call their own economist to refute the FTC's expert testimony and to develop their defense, however, was a precarious move that undoubtedly made the judge's job more difficult.

The government's typical strategy in the past has been to call the merging parties' executives in its case in chief, which allows the regulator to set the tone of the testimony. In this case, however, the FTC elected to allow the merging parties to call their respective executives as part of the defense. As a result, when the defendants rested their case without calling any witnesses, the FTC did not have an opportunity to elicit evidence from Staples and Office Depot executives through cross-examination or otherwise.

The Decision

District Judge Sullivan ultimately ruled in the FTC's favor, stating that the agency had met the burden of showing that there is a reasonable probability that the Staples-Office Depot merger would substantially impair competition in the sale and distribution of consumable office supplies to large B2B consumers. He noted that the decision ultimately "hinge[d] on two critical issues: (1) the reliability of [the FTC's] market definition and market share analysis; and (2) the likelihood that the competition resulting from new market entrants like Amazon Business will be timely and sufficient to restore competition lost as a result of the merger."

The judge found that the evidence supported the product market alleged by the FTC because, among other things, large B2B customers have distinct needs (requiring specialized vendors with sophisticated capabilities) and ink and toner are subject to "distinct competitive conditions" (given the existence of alternative vendors, including managed print services). He also broadly accepted the FTC's expert testimony relating to market shares.

Confirming that the relevant temporal scope for considering prospective entry into the market is three years, Judge Sullivan determined that Amazon Business would not be in a position to replace the competition lost as a result of the proposed merger within that time frame. He relied in large part on testimony from customers and Amazon Business' executive, which tended to show that customers do not presently view the company as a viable alternative and are unlikely to shift large office supply purchases to it in the near future. The judge further opined that W.B. Mason and other regional players do not have the resources to serve large national customers and underscored that W.B. Mason's executive testified that the company did not have the "desire or the ability to compete" on that scale.

Significantly, throughout his decision, Judge Sullivan repeatedly cited the merging parties' "bad" documents and that they could have but elected to not offer any evidence in their defense.

Conclusion

The District Court's decision in *FTC v. Staples* highlights a number of important considerations that parties contemplating a transaction should keep in mind, including the following:

- Parties should be aware of the importance of their internal documents, which can affect the length and outcome of any regulatory review and litigation proceeding. "Bad" documents that include unhelpful statements about how the merging parties view each other continue to attract the attention of antitrust agencies and courts.
- The District Court endorsed once more a national product market, underlining that markets and competitive effects analyses can be based on a particular customer or particular group of customers—and even the largest customers can be harmed by a loss of competition.

The FTC is likely to consider whether it should have called Staples and Office Depot executives in its case in chief, and it remains to be seen whether this case will have an impact on the FTC's general approach in merger litigation going forward. It seems unlikely, however, that anyone will try the losing strategy of not presenting a defense in a preliminary injunction hearing against the FTC again.

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