

CLIENT ALERT

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FTC Blocks Staples' Acquisition of Office Depot

SPEED READ

In yet another example of the Obama Administration's continued vigorous enforcement of the antitrust laws, the Federal Trade Commission successfully sued and ultimately blocked the acquisition of Office Depot, Inc. by Staples, Inc. This litigation provides another reminder to potential merging entities that a careful assessment of the antitrust risks is an essential component to any transaction and that closing is by no means guaranteed, especially where the merging parties are close competitors and where the parties' defenses are predicated closely on concepts of new and disruptive entrants. Below, we provide a detailed overview of the litigation itself, as well as some key takeaways for clients considering their own transactions.

INTRODUCTION

After more than a year-long battle with the Federal Trade Commission (FTC), the proposed acquisition of Office Depot, Inc. (ODP) by Staples, Inc. (SPLS) was blocked by the Honorable Emmet G. Sullivan of the U.S. District Court for the District of Columbia.^[1] Judge Sullivan found that the FTC had met its burden under Section 7 of the Clayton Act and showed there was a reasonable probability that the proposed merger substantially would lessen competition in the sale and distribution of consumable office supplies to large Business-to-Business customers. The Court also found that the FTC had carried its burden of showing that a preliminary injunction preventing the proposed merger was in the public interest and that the equities weighed in favor of injunctive relief. Shortly after Judge Sullivan announced his decision, SPLS and ODP abandoned the transaction.^[2]

PROCEDURAL HISTORY

SPLS and ODP announced their intent to merge in February 2015. Thereafter, the FTC began an investigation into the likely competitive effects of the \$6.3 billion proposed merger. On December 7, 2015, by a unanimous vote, the FTC Commissioners found reason to believe that the proposed merger would substantially lessen competition in violation of Section 7 of the Clayton Act.^[3] That same day, the FTC filed a federal lawsuit to enjoin the proposed merger pending completion of a full trial back in the FTC's in-house administrative tribunal. The Court presided over an evidentiary hearing from March 21 to April 5, 2016. Many were surprised at the evidentiary hearing when the defendants chose not to present any witnesses, instead resting at the close of the FTC's case and arguing that the FTC had failed to carry its burden.

THE SECTION 13(B) STANDARD OF REVIEW

Unlike transactions being reviewed by the FTC's sister antitrust enforcement agency, the Department of Justice's Antitrust Division, the SPLS ODP injunction hearing proceeded under Section 13(b) of the Federal Trade Commission Act. Because the FTC is an independent administrative agency, it operates using this unique standard that is somewhat different from a traditional preliminary injunction standard. The Section 13(b) standard requires the FTC to show only two things to win the preliminary injunction: (i) a likelihood of success on the merits which has been interpreted to mean the FTC must raise questions so serious, substantial, difficult, and doubtful, as to make it fertile ground for a full trial in the FTC's administrative tribunal; and (ii) that the equities tip in favor of injunctive relief.

THE COURT'S OPINION

The central dispute involved the definition of the proper relevant product market from which to assess the likely competitive effects of the proposed merger. Ultimately, the Court sided with the FTC in most every way and to understand the Court's reasoning, we break down each of the determinations made by the Court in reaching its conclusion.

The Court found that FTC had established a Relevant Product Market of Consumable Office Supplies Sold and Distributed by the Defendants to Large Business-to-Business Customers

The Court held that the evidence presented supported the FTC's allegation that the market of consumable office supplies sold and distributed by the defendants to large Business-to-Business customers is a relevant product market for antitrust purposes.^[4] In so concluding, the Court relied on evidence presented by the FTC that:

- There is industry or public recognition of this market as a separate and distinct economic entity;
- Business-to-Business customers demand distinct prices through differentiated negotiation and contracting practices and demonstrate a high sensitivity to price changes; and
- Business-to-Business customers require specialized vendors that offer value-added services, including sophisticated information technology services, high quality and personalized customer service, and expedited next day and desktop delivery.

As a result, the Court agreed that the relevant market could be established by focusing on sales of a *cluster* of goods (i.e., *consumable office supplies*), consisting of an assortment of office supplies such as pens, paper clips, notepads and copy paper that are used and replenished frequently) to a *targeted* set of customers (i.e., large Business-to-Business customers who spend \$500,000 or more on office supplies annually). Tellingly, the Court stressed that the "[a]ntitrust laws exist to protect competition, **even for a targeted group that represents a relatively small part of an overall market**" (emphasis added) and that there was overwhelming evidence presented by the FTC that such large Business-to-Business customers constituted a market that SPLS and ODP could target for price increases if they were allowed to merge.

The Court found that the FTC had established its *Prima Facie* case by demonstrating that the merger would result in an *Increase in Market Concentration above Competitive Levels*

The Court next held that the FTC had met its burden of showing that the merger would result in undue concentration in the relevant sale and distribution of consumable office supplies to large Business-to-Business customers in the United States. SPLS allegedly captured ~47% and ODP allegedly had ~32% market share of Fortune 100 customers, for a potential combined postmerger total of 79% market share. The relevant Herfindahl-Hirschmann Index ("HHI")^[5] in this case purportedly would have risen nearly 3000 points, from 3270 to 6265, which far exceeded the levels deemed to raise a presumption that the merger was illegal.

The Court found that FTC had established that the merger would eliminate important *Head-to-Head Competition between Close Competitors Resulting in Lessening of Competition*

In addition to considering market concentration, the Court also reviewed substantial evidence suggesting that the companies were critical head-to-head competitors for large Business-to-Business accounts. Principally:

- The Court examined SPLS' and ODP's win-loss and bid data and found that it demonstrated that they won large Business-to-Business customer bids more frequently from each other than other bidders;
- The Court found that SPLS' and ODP's own documents created in the ordinary course of business showed that they viewed only themselves as the most viable office supply vendors for large businesses in the United States; and
- The Court accepted witness testimony from large Business-to-Business customers who stated their views that SPLS and ODP were their best options for nationwide sale and delivery of consumable office supplies and that, absent an independent ODP, they would lose tremendous leverage and likely have to pay higher prices for consumable office supplies.

The Court did not find persuasive the defendants' argument that the merger was not anticompetitive because of *Potential Entry from Amazon Business or Others*

The Court rejected arguments that Amazon Business and other local and regional office supply companies would restore the competition lost postmerger. The Court reasoned that while Amazon Business may someday become a behemoth in office supplies, Amazon Business currently faces a multitude of challenges that prevent it from being on equal footing to the offerings of SPLS and ODP, including: a lack of RFP experience, no commitment to guaranteed pricing, lack of ability to control third-party agent pricing and delivery, inability to provide customer-specific pricing, lack of dedicated customer service agents in the Business-to-Business space, no desktop delivery, no proven ability to provide detailed utilization and invoice reports, and a lack of product variety and breadth. As a result, large Business-to-Business customers did not view Amazon Business as a viable alternative to SPLS and ODP. Similarly, the Court rejected the notion that regional competitors such as WB Mason had the desire or wherewithal to expand to take on SPLS and ODP on a large, national scale.

The Court concluded that the *Public and Private Equities Favored Enjoining the Merger*

Lastly, the Court found that, because it was clear that the merger was likely to lessen competition in the relevant market, the public interest in antitrust enforcement also weighed heavily in favor of enjoining the merger pending the full trial in the FTC's administrative tribunal. Essentially, the Court found that preserving the FTC's ability to order effective relief also weighed in favor of enjoining the proposed merger.

CRITICAL TAKEAWAYS FOR CLIENTS

This important FTC victory provides an opportunity for clients to refresh and reaffirm several critical antitrust themes to keep in mind when thinking about their own potential mergers and acquisitions. Principally:

- U.S. antitrust enforcers will and successfully can allege a relevant market that is based on narrow sales of focused *clusters* of products sold to *targeted* groups of customers, no matter how small or focused that relevant market may seem;
- Market shares and concentration levels (and even HHI calculations) still matter and courts will use those to presume anticompetitive effects of a proposed merger;
- Courts will carefully scrutinize companies' bidding data – whom you have beat and to whom you have lost carry significant weight;
- Ordinary course documents remain supremely important and lay the foundation for how the U.S. antitrust enforcers regard the likely competitive effects;
- Factual testimony from customers is also a key driver to likelihood of success (or not). It is crucial to have an honest understanding regarding what customers will tell antitrust enforcers; and
- Merging parties cannot expect to see their deals released from antitrust scrutiny by relying on assertions that there exist large and otherwise highly successful technology companies who would be credible entrants that will expand rapidly into their markets postmerger. Put differently, successful entry arguments are hard and the evidence must be overwhelming to convince the FTC or a Court that the entry will be likely, timely and sufficient.

To discuss this alert or any potential transaction, please feel free to contact any member of the Goodwin Procter Antitrust & Competition Team.

^[1] The decision was announced on May 10, but the public version of the opinion was not released until one week later on May 17, 2016.

^[2] This was, of course, not the first time that these parties suffered such a defeat – in 1997, a proposed merger between Staples and Office Depot was also enjoined by the U.S. District Court for the District of Columbia. By contrast, in 2013, after a seven-month investigation, the FTC chose not to challenge Office Depot's proposed acquisition of Office Max.

^[3] Section 7 of the Clayton Act prohibits mergers or acquisitions "the effect of [which] may be substantially to lessen competition, or to tend to create a monopoly," in any "line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. §18.

^[4] While geographic market definition is an important component of antitrust analysis, all parties had previously stipulated that the United States was the relevant geographic market.

^[5] The HHI is a tool used by economists to measure changes in market concentration. HHI is calculated by summing the squares of the individual firms' market shares. A market with an HHI above 2500 is considered to be "highly concentrated" and a merger that results in a highly concentrated market that involves an increase of 200 points will be presumed to be likely to enhance market power.

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