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May 20, 2016

## **Federal Court Blocks Staples-Office Depot Merger, Finding Sale of Office Supplies to Large Business Customers to Be a Distinct Relevant Market**

On May 10, 2016, the United States District Court for the District of Columbia ruled that the Federal Trade Commission successfully established a *prima facie* case that the proposed merger of Staples and Office Depot was “likely to reduce competition in the Business to Business (‘B-to-B’) contract space for office supplies.” Op. at 4, *FTC v. Staples, Inc.*, 15-cv-02115 (D.D.C. May 17, 2016).<sup>i</sup> The parties abandoned the transaction the same day. The decision marks the second time a federal court has sided with the FTC and blocked a deal between Staples and Office Depot. The court’s opinion sets forth a detailed relevant market analysis, and underscores the importance identifying various types of customers when performing that analysis. The case is also a reminder of the importance of thorough presentation of evidence to courts deciding merger cases, and of the high-stakes consequences of preliminary injunction merger challenges.

### **Background**

This is not the first time Staples and Office Depot have tried to merge. In 1997, Staples, an office products retailer, proposed to acquire Office Depot, also an office products retailer. The parties abandoned this merger when the FTC obtained a preliminary injunction against the deal. See *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997). In that proceeding, the FTC alleged that the transaction would be likely to substantially reduce competition for “the sale of consumable office supplies *through office superstores*” (e.g., “paper, pens, file folders, post-it notes, computer disks, and toner cartridges”). *Id.* at 1073 (emphasis added). At the time, Office Depot and Staples were the two largest office superstores in the country. *Id.* at 1069. The defendants there argued that the FTC’s proposed product market definition was “contrived” and the correct product market comprised “simply the overall sale of office products, of which a combined Staples-Office Depot accounted for 5.5% of total sales in North America in 1996.” *Id.*

The court in 1997 rejected this broader market definition, and found that the FTC demonstrated a substantial likelihood of success in proving that the deal would substantially reduce competition. *Id.* at 1091. The court cited evidence that in geographic markets where there was only one office superstore, prices for a “sample accounting for 90% of Staples’ sales and comprised of both price sensitive and non[-]price sensitive items were significantly higher” than prices where there was more than one superstore. *Id.* at 1075-76. The evidence “suggest[ed] that office superstore prices are affected primarily by other office superstores and not by non-superstore competitors such as mass merchandisers, . . . independent retail office supply stores, mail orders firms. . . , and contract stationers” *Id.* at 1077. In addition, the

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court cited evidence that the parties “change[d] their price zones when faced with entry of another superstore, but d[id] not do so for other retailers.” *Id.* at 1077-78. Having determined that the relevant market was the sale of consumable office supplies by office superstores, the court examined the effect of the merger on market concentration in various geographic markets and agreed with the FTC that in certain markets the concentration increases would be likely to substantially lessen competition. *Id.* at 1083.

In 2013, Office Depot proposed to acquire OfficeMax, another office supply superstore. After a seven-month investigation, the FTC decided *not* to challenge this deal.<sup>ii</sup> The FTC explained “that the market for the sale of consumable office supplies has changed significantly” since its challenge to the Staples-Office Depot merger. *Id.* According to the FTC, the market had expanded: consumers now looked to “[m]ass merchants like Wal-Mart and Target and club stores like Costco and Sam’s Club [which had] proliferated and expanded their product offerings and sales of office supplies,” as well as online retailers. *Id.* The FTC found that, unlike in 1997, “merging parties’ pricing policies and practices reflect these changes in customer behavior and now specifically factor in non-OSS competition.” *Id.* The FTC also noted that, “large multi-regional or national customers. . . use a variety of tools to ensure that they receive competitive pricing such as ordering certain products (like ink and toner) directly from manufacturers . . . [and that] the merging parties’ documents show[ed] that they are rarely each other’s closest competitor for most large customers.” *Id.*

Following Office Depot’s acquisition of Office Max, Staples and Office Depot once again proposed to merge. The FTC moved to block the deal by seeking a preliminary injunction. In doing so, the FTC alleged a relevant market for “the sale and distribution of consumable office supplies to large B-to-B [business-to-business] customers.” Mem. in Supp. of Pls.’ Mot. for Prelim. Inj., *FTC v. Staples, Inc.*, 15-cv-02115 (Feb. 19, 2016), at 11. (B-to-B consumers are “businesses buying office supplies for their employees’ own use.”) *Id.* at 1. In particular, the “case focus[ed] on large B-to-B customers, defined by Plaintiffs as those that spend \$500,000 or more per year on office supplies.” Op. at 9.

The court conducted a preliminary injunction hearing in which it received evidence, including expert and customer testimony, from the FTC in late March and early April of this year. Staples and Office Depot elected to not call any witnesses, but rather rested at the close of the government’s case. The court sided with the FTC and issued a preliminary injunction.

### **The Court’s Opinion**

The court’s opinion turned on the definition of the relevant market, about which “the parties vigorously disagree[d].” Op. at 19. The court first found that it was appropriate, where a retailer sells many varied items, to analyze a “cluster market.” Op. at 20. This “allow[s] items that are not substitutes for each other to be clustered together in one antitrust market for analytical convenience.” *Id.* Accordingly, the court proceeded to analyze the potential effect on competition in a cluster market comprising consumable

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office supplies. Op. at 21. The court also found that it was appropriate to define the market with reference to “targeted consumer[s]” (*i.e.*, large businesses). Op. at 22. The defendants contested this limitation: they complained that the government inappropriately limited its analysis to “large B-to-B customers” and “gerrymandered” the product market to include “*some*, but not all, consumable office supplies sold to only the most powerful companies in the world.” Defendants argued that printer ink and toner, in particular, “must be included in a proper definition of the relevant product market.” Op. at 23-24.

Siding with the government on market definition, the court found that “the industry recognizes large B-to-B customers as a separate economic entity” (Op. at 26); that such customers “are extremely price sensitive” and have pitted Staples and Office Depot against each other in order to negotiate for lower prices (Op. at 27-28); and that they are distinct in demanding “sophisticated IT capabilities” (which “are expensive and therefore offered by only a select few nationwide vendors”), “personalized customer service, and expedited delivery capabilities” nationwide. Op. at 28-31. The court also agreed with the government’s expert economist that “the elimination of competition [between Staples and Office Depot] would lead to a significant price increase to large customers.” Op. at 33.

The court was unpersuaded by defendants’ arguments concerning market definition. Specifically, defendants argued that the government improperly excluded printer ink and toner and “beyond office supplies” products from the market. Op. at 34. The court, however, found that ink and toner were not “subject to the same competitive conditions” as other office supplies because “competition for the sale of ink and toner has increased due to the ‘recent and rapid’ rise of Managed Print Services.” Op. at 36. The court was also unpersuaded by the argument that the FTC’s earlier proceedings concerning proposed office supply superstore mergers included ink and toner in the relevant market. The court held that

scant precedential value can be gleaned from comparing the defined market in [the 1997 Staples-Office Depot] case and the Plaintiffs’ alleged market in this case. The 1997 case is nearly twenty years old, and the office supply market has changed dramatically since that time. . . . [T]he 1997 Staples case was a retail case that focused on how the proposed merger would affect the average consumer. The case before the Court today is a contract channel case focused on large B-to-B customers.

Op. at 40-41. The court also found distinct competitive conditions relating to “beyond office supplies” products that were not present for office supplies. Op. at 37.

Defendants also argued that the government improperly limited the market to large B-to-B customers. But the court found that

the nature of how large B-to-B customers operate, including the services they demand, supports a finding that they are a targeted customer market for procurement of consumable office supplies. There is overwhelming evidence in this case that large B-to-B

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customers constitute a market that Defendants could target for price increases if they are allowed to merge.

Op. at 45. The court cited defendants' own documents demonstrating that when making pitches to customers, defendants specifically raised the specter of reduced competition as a reason that customers should lock in prices before the merger closed. *See* Op. at 45-46.

Based on such evidence, the court agreed with the government's expert economist that "Staples and Office Depot currently operate in the relevant market as a 'duopoly with a competitive fringe'" and that the increase in market concentration from the proposed merger would result in the creation of "one dominant firm." Op. at 49-50. The government calculated market shares by examining purchase data from a survey of eighty one of the *Fortune* 100 companies, Op. at 48-49, and the court rejected defendants' challenge to this methodology because of the defendants' failure to present expert evidence in rebuttal. Op. at 51-53.

Noting that "sole reliance on [market concentration] calculations cannot guarantee litigation victories," Op. at 56-57, the court also reviewed and gave weight to additional evidence that the government would be likely to succeed in proving that the merger may substantially lessen competition. In particular, the court looked to defendants' bidding data, which showed that defendants engaged in head-to-head competition and that they "win large B-to-B customer bids more frequently than other bidders," Op. at 58, and to their ordinary course documents, which demonstrated that customers pit Staples and Office Depot against each other to receive price concessions. Op. at 59.

Finally, the court did not credit defendants' argument that "Amazon Business, as well as the existing patchwork of local and regional office supply companies, will expand and provide large B-to-B customers with competitive alternatives" within three years -- which the court accepted as the relevant time period to analyze the effects of possible market entry on competitive conditions. Op. at 61-62. The court found that "the evidence . . . does not support the conclusion that Amazon Business will be in a position to restore competition lost by the proposed merger within three years." Op. at 64.

### **Significance**

The court's decision reflects a straightforward application of market definition analytical techniques. But the outcome serves as a reminder that a thorough market definition analysis is an important step in analyzing the antitrust risks of a proposed deal. This analysis may be quite nuanced and may involve asking questions about particular products, particular types of customers, and the particular behavior of customers when purchasing the products at issue. Where suppliers have several different types of customers, an analysis may need to be performed for each customer type. By accepting a market defined in part by sales to large customers, the decision also echoes the result in last year's successful challenge by the FTC to the proposed merger of Sysco and US Foods. In that case, Judge Amit Mehta – also of the

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federal district court in Washington, D.C. – found that the FTC had established the existence of a market based in part on those companies’ “distinct customers.”<sup>iii</sup>

The *Staples* case also serves as a reminder that market conditions change, and that parties cannot rely on the government’s past determinations – even relatively recent ones. For example, in approving the 2013 merger of OfficeMax and Office Depot, the FTC found that “the parties will continue to face strong competition for such customers from Staples and a host of non-OSS competitors, such as W.B. Mason Co., Inc.” OfficeMax Closing Statement at 3. Here, the FTC took the opposite position, arguing that W.B. Mason and other non-OSS companies were not significant competitors to Staples or Office Depot. Defendants pointed out the apparent contradiction, but it did not sway the court, which found that “W.B. Mason and other regional and local office supply vendors are at a competitive disadvantage because they do not have the resources to serve large customers nationwide.” Op. at 70-71. Similarly, defendants argued to no avail that “[t]he FTC itself used a different market definition when it analyzed the retail office products market in 1997, and again in late 2013, when it considered ink and toner to be part of a ‘consumable office supplies’ relevant market.” Defs.’ Prop. Findings of Fact, *FTC v. Staples, Inc.*, 15-cv-02115 (D.D.C. Apr. 20, 2016).

The court’s citation of the parties’ internal documents highlights the need for careful antitrust counseling to businesspeople with respect to business communications, especially communications relating to the deal. The agencies will see these documents, and they will have a profound effect on the way the government will evaluate the deal. Contemporaneous business documents may carry much greater weight in the enforcers’ minds than *post hoc* arguments made to urge clearance of the deal. In addition, the case highlights the perils of not presenting a rebuttal case: here the defendants rested at the close of the government’s case and did not call any of their own witnesses. In siding with the government, the court several times noted that lack of evidence from the defendants.

Finally, as the court the court noted, this case once again demonstrates that the stakes for a preliminary injunction hearing in the merger context are high: an “unfortunate reality of antitrust statutes” is “the lack of meaningful appellate review on the merits” of merger challenges. Op. at 4. “Because the administrative process before the FTC is so time consuming, most corporations, like Defendants in this case, cannot secure financing to keep the deal together pending the administrative trial on the merits.” *Id.*

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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i The court's full opinion was docketed under seal. On May 17, 2016, the court released a redacted opinion to the public. The opinion is available at [https://ecf.dcd.uscourts.gov/cgi-bin/show\\_public\\_doc?2015cv2115-455](https://ecf.dcd.uscourts.gov/cgi-bin/show_public_doc?2015cv2115-455).

ii See Stmt. of the Fed. Trade Comm'n Concerning the Proposed Merger of Office Depot, Inc. and OfficeMax, Inc., F.T.C. File No. 131-0104 ("OfficeMax Closing Statement"), available at [https://www.ftc.gov/sites/default/files/documents/closing\\_letters/office-depot-inc./officemax-inc./131101officedepotofficemaxstatement.pdf](https://www.ftc.gov/sites/default/files/documents/closing_letters/office-depot-inc./officemax-inc./131101officedepotofficemaxstatement.pdf).

iii See Paul, Weiss Client Memo, Federal Judge Preliminarily Enjoins Sysco-US Foods Merger and Parties Abandon the Transaction (July 2, 2015), available at <https://www.paulweiss.com/practices/litigation/litigation/publications/federal-judge-preliminarily-enjoins.aspx?id=20163#sthash.Eb4YJmpo.dpuf>.