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U.S. DISTRICT COURT
DISTRICT OF COLUMBIA

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FEDERAL TRADE COMMISSION

Plaintiff,

vs.

STAPLES, INC.

and

OFFICE DEPOT, INC.

Defendants.

Case No: 1:97CV00701
Judge: TFH

PLAINTIFF'S REPLY TO DEFENDANTS' MEMORANDUM OF LAW IN OPPOSITION TO THE FEDERAL TRADE COMMISSION'S MOTION FOR A PRELIMINARY INJUNCTION

DATED: May 8, 1997

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Introduction

Defendants' Memorandum of Law in Opposition to the Commission's Motion for a Preliminary Injunction ("DB") is long on hyperbole, but curiously fails to join issue on the key facts. The crux of this case, like any merger case, is whether the merger enhances the ability of the merged firm to raise prices. Here comprehensive data assembled by the defendants shows that competition between office superstores drives lower prices. Prices are higher where office superstore competition is lacking. Defendants' own documents corroborate the statistical evidence of this competitive interplay, showing that Staples saw Office Depot as its key rival and lowered prices in markets where the two competed. These powerful real world facts simplify the predictive process courts usually go through in determining whether to stop an anticompetitive merger. Competition will be profoundly impaired if Staples acquires its principal rival.

The Federal Trade Commission's ("FTC" or "Commission") fact-specific Memorandum of Points and Authorities in Support of its Motions for Temporary Restraining Order and Preliminary Injunction ("FTC Brief") cites extensively to the defendants' price evidence, admissions from their own documents and deposition testimony, and extensive third party affidavits. Although the defendants denigrate this evidence as merely "theoretical musings" (DB at 32), they do not rebut it or offer any explanation as to why their pricing behavior should not be deemed the most reliable indicator of their future intentions.

The defendants' own documents and comprehensive pricing data show that:

- Superstore competition causes lower prices in markets where Staples and Office Depot compete and the absence of competition causes prices to rise. FTC Brief at 30. The merger eliminates that competition in some 42 areas of the country;

- Staples and Office Depot are fast growing firms, poised to invade each others markets and expand the competitive battlefield. The merger eliminates significant future competition between Staples and Office Depot and denies consumers lower prices that otherwise would have resulted. FTC Brief at 30-32;

- The merger was motivated by concern over the prospect of Office Depot, Staples and OfficeMax invading each other's territories. FTC Brief at 5-6, 27-28. Industry analysts lauded the proposed merger, not for efficiencies and lower prices, but rather because it would eliminate "the lingering fear of intensified competition in three-player markets" (PX 53 at 0401) and create "considerable market power" in the hands of the two surviving office supply superstore firms. PX 57 at 1127; and

- The merger already is causing anticompetitive effects.

Rather than confront this evidence of their past behavior and the merger's likely competitive harm, Staples brief in opposition reads like its high-powered public relations campaign. The exhibits referenced in their opposition brief consist largely of a full page ad where Staples promises to lower prices, selected newspaper articles and editorials that restate that promise, and a few lawyer-crafted form affidavits signed by suppliers that suggest that there might some day be some amount of cost savings from this merger.

This "promise" of lower prices is no defense to an illegal merger. It is competition, not benevolent intentions, that drives the incentive to lower prices and cut costs. In enacting the antitrust laws, Congress chose to rely on competition to produce optimal performance (including low prices), not on the promises of business people exercising market power. Competition is what led to the success of the parties today. Staples' promise to exercise benevolently its ill-gotten market power is no substitute. FTC v. Food Town Stores, 539 F.2d 1339, 1346 (4th Cir. 1976) (rejecting merging parties' testimony promising to lower prices because parties could thereafter "adjust prices upwards"); Mississippi River Corp. v. FTC, 454 F.2d 1083, 1089 (8th Cir. 1972) ("honest intentions" are not a defense to a violation of § 7).

I. THE OFFICE SUPERSTORE MARKET IS FIRMLY SUPPORTED BY THE LAW AND FACTS HERE

Defendants' brief is not short on adjectives, claiming in various places that the office superstore market is "artificial;" "unreal;" "artificially shrunk;" "procrustean;" "unprecedented;" and "gerrymandered." But in attacking the Commission's product market, defendants do not even attempt to address two key economic realities:

- Office superstores establish their prices primarily based on the extent of competition from other superstores; and
- The actual pricing of both Staples and Office Depot confirms that office superstores have the most prominent effect on pricing and that other retailers have little effect.

The purpose of defining a relevant market is to gauge the competitive effects of a merger. Defendants concede and we agree, that market definition is not an end in itself but rather a means to determine whether a "merger will substantially lessen competition." DB at 20. The point is to identify the effect on competition, not the precise market boundary. United States v. General Dynamics Corp., 415 U.S. 486, 521 (1974) (a relevant market need not be defined by "metes and bounds").

The defendants' position is that an office superstore market is too narrowly defined because other firms sell some office products at retail. We readily admit that there is some competitive interplay between office superstores and other retailers. But the fact that other retailers sell some office supplies does not require inclusion of those firms in the relevant market.[1] Rather, as the Supreme Court has instructed, the market must exclude those products or firms to which "only a limited number of buyers will turn; in technical terms, products whose cross-elasticities of demand are small." Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 612 n.31 (1953); see United States v. Aluminum Co. of America, 377 U.S. 271, 275 (1964); United States v. Gillette Co., 828 F. Supp. 78, 81 (D.D.C. 1993). Furthermore, even in a market which includes those retailers, the transaction is problematic for two reasons. First, the evidence and the law support a distinct office superstore submarket. Second, the transaction will give the merged firm market power even if other retailers are included.

First and foremost, the evidence shows that office supplies sold through office superstores are a relevant product market or submarket.[2] The critical question is whether a sufficient number of consumers will switch to other sellers of office products in the event of a 5 percent price increase so as to make the price increase unprofitable. The answer -- based on the current pricing of the defendants -- is that consumers in many parts of the country have not switched

[1] Defendants claim that "a proper product market consists of all 'commodities reasonably interchangeable by consumers for the same purposes,'" DB at 13, quoting United States v. E.I. DuPont De Nemours & Co., 351 U.S. 377, 395 (1956). Of course, the Supreme Court said nothing about including "all" reasonably interchangeable products as the brief seems to suggest; instead the Court focused on the cross-elasticity of demand, i.e., the extent to which one product would be substituted for another in response to changes in price.

[2] While the Merger Guidelines market definition test speaks in terms of whether a hypothetical monopolist can profitably raise price, in this case we need not rely on the "hypothetical" monopolist, for there is evidence applying an "actual" monopolist test in pricing evidence of Staples and Office Depot. FTC Brief at 16-17; PX 3; United States Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,104 (Apr. 1992). This evidence shows that office superstores can and do maintain higher prices and profit margins in markets where they face no office superstore competition. None of this evidence is seriously disputed by defendants.

to alternative sellers despite sustained price differentials exceeding 5 percent. This demonstrates that these alternative sellers are not in the relevant market.[3]

The pricing data do not stand alone. Other evidence from the defendants' own files (including numerous documents they have filed as exhibits) demonstrates that they focus principally on competition from office superstores. FTC Brief at 20-21; PX 228-29; PX 264 at 2826;

DX 521 at 6117-18 (same);

Here are four illustrative examples:

- Defendants' pricing strategies and price zones are based primarily on the extent of office supply superstore competition in a particular region. ; With rare exceptions, other retailers are not considered in establishing a price zone;[4]

- Defendants' elaborately prepared "market saturation" studies

- ; PX 79 at 1238, ; and

[3] Defendants argue that the FTC is mistaken in suggesting that the differences in prices are explained exclusively by the presence or absence of office superstores. That simply mischaracterizes the government's position. Rather, the evidence is that prices are lower where there is superstore competition than where it is absent, price differences are not explained by other factors, and a substantial portion of the difference appears to flow from the presence or absence of superstore competition.

[4] Defendants' own documents that show whom they priced against are particularly probative. Tasty Baking Co. v. Ralston Purina, 653 F. Supp. 1250, 1259 (E.D. Pa. 1987) (evidence of bakers' pricing practices and other internal documents supports market limited to snack cakes and pies). See FTC v. PPG Indus., 628 F. Supp. 881, 884 n.5 (D.D.C.), aff'd, 798 F.2d 1500 (D.C. Cir. 1986); see also FTC brief at 20, n.20.

- Even though defendants claim these other retailers compete with the superstores, they have not shown even one instance where office superstore chains lowered prices in response to entry by one of the retailers in any way similar to the price response when another office superstore enters. In contrast, their own documents are rife with examples of how superstore entry caused the incumbent superstore to lower price. FTC Brief at 30 n.29; PX 3 at Tab E

Defendants try to obscure the importance of the method of distribution in defining the relevant market by claiming that an office superstore market definition erroneously focuses on the role of sellers. DB at 12, 13. But defendants miss an important reality: where a consumer shops is often as important to the consumer as what is purchased. Consumers make two decisions: what to purchase and where to purchase. When a consumer wants to make a single trip for groceries, Giant and Safeway are reasonable alternatives, a 7-11 is not. Similarly, when a consumer wants to shop for a wide variety of office supplies and wants to compare alternatives, a mass merchandiser with limited offerings is not an effective substitute for an office superstore. PX 179 at ¶¶ 6-8 (other retailers do not offer the range of product or breadth of selection of office superstores); PX 180 at ¶ 3; PX 182 at ¶¶ 4,5; PX 183 at ¶ 4. Thus, courts have often defined markets to include both the means of distribution and the products sold. Indeed, it matters to consumers that there is one place where they can obtain a unique combination of goods and services; the "cluster market" captures that concept.[5] Courts have

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[5] FTC brief at 18-19. Defendants appear to admit that cluster market are legitimate. They cite two cases where cluster markets were not found, but those cases lacked the pricing evidence, presented in this case, showing that participants in the cluster have a unique effect on each other's pricing. Thurman Indus. v. Pay 'n Pak Stores, 875 F.2d 1369, 1376 (9th Cir. 1989) (specifically noting plaintiff's failure to present pricing evidence); Westman Commission Co. v. Hobart Int'l, 796 F.2d 1216, 1222 (10th Cir. 1986) (reversing finding of cluster market where lower court found that market participants in that cluster market faced direct competition from others such that "raising the price of [its] products likely would lead many customers to purchase competing brands"), cert. denied, 486 U.S. 1005 (1988).

(continued...)

used the term "submarket," to refer to narrower relevant markets within broader markets, or evidentiary proxies showing that the market is narrow rather than broad. FTC Brief at 22 (discussing cases). Office superstores are an appropriate market regardless of which analytical construct is used. In either case, the issue is the evidence, and the evidence in this case provides persuasive proof that the sale of office supply consummables through office superstores is a relevant market.

Nevertheless, even if the relevant market is expanded to include mass merchandisers and other retailers -- such as Wal-Mart, Kmart, Target, Sam's Club, BJ's Warehouse Clubs, Price/Costco, Best Buy, Computer City, and CompUSA, and independent stationers -- the acquisition still raises a significant risk of anticompetitive effects. FTC Brief at 26-27.

Defendants also argue that contract stationers and mail order firms are in the product market. But the evidence shows that not enough office superstore customers will turn to these alternatives to defeat an anticompetitive price increase. First, contract stationers' customer base is almost exclusively medium and large-sized businesses that are not the primary customers of the office superstores. PX 197 at ¶¶ 3,5 (contract stationers primarily serve medium and large businesses); (retail is in a "different market" from contract stationers). In sharp

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[5](...continued)

Another case the defendants rely upon shows the error of differentiating between services and the attendant products. In M.A.P. Oil Co. v. Texaco, 691 F.2d 1303 (9th Cir. 1982), the court rejected efforts to create an artificial distinction between a product -- gasoline -- and the attendant services that usually were purchased together with the gasoline for one price. Similarly, here, defendants focus narrowly on the items of office supplies and ignore the attendant services -- particularly the breadth and depth of offering -- that are an "integral" part of the total package of products and services that office superstores offer. Id. at 1307.

contrast, the customer base of office superstores overwhelmingly is small businesses with fewer than 20 employees and consumers with home offices. PX 214 at 147 (Office Depot's "primary customer" base is businesses with less than 20 employees);

[6]

Second, mail order is higher priced and decidedly less convenient for customers.[7] Courts repeatedly emphasize that evidence of price differences over time demonstrates that insufficient consumers will switch away from the outlets in question to defeat an anticompetitive price increase and thus signifies the existence of a separate product market or submarket.[8]

6/ Other non-retail vendors -- sometimes called "commercial dealers" -- also have testified that they cannot constrain office superstores' pricing because they serve different customers. PX 178 at ¶ 5 (Leimkuhler) (commercial dealers target medium size customers with 25-50 employees -- customers that typically do not use office superstores); ; PX 196 at ¶ 4 (Tylander); PX 201 at ¶¶ 9-10, 14 (Office Network).

7/ FTC Brief at 18 n.18; PX 150 at 0726 (Office Depot CEO states that office superstore prices are generally at least 10% to 15% lower than mail order); , PX 212 at 67 (superstore prices remain 10% to 15% lower than mail order today);

PX 206 at 140 (average order size for Staples mail order is $155-65, compared to average retail purchase of $35);

); PX 174 at ¶ 14 (Wal-Mart) (mail order firms do not affect pricing at office superstores).

8/ Reynolds Metals Co. v. FTC, 309 F.2d 223, 229 (D.C. Cir. 1962) ("price

(continued...)

Moreover, in many cases courts have defined markets by separating lower priced products and services from higher priced ones.[9]

II. COMPELLING EVIDENCE SHOWS THAT THE MERGER WILL SUBSTANTIALLY LESSEN COMPETITION

The ultimate determination in a merger case is whether the merger will "substantially lessen" competition. On this issue, the defendants' own documents and pricing evidence are again compelling. They show that:

- the merger will result in a substantial increase in concentration and prices: monopolies in 15 markets and duopolies in 27 markets;
- both Staples and Office Depot price higher where there is little or no superstore competition;[10]
- once the merger was announced Staples

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[8](...continued)
differentials have an important if not decisive bearing"); Gillette Co., 828 F. Supp. at 82 (finding separate product market for writing instruments in the $50 to $400 range based on evidence that consumers would not switch, in the event of a price increase, to cheaper instruments); see Alcoa, 377 U.S. at 275-77 (price differential "single, most important practical factor" in finding that insulated aluminum was a market separate from insulated copper conductor); United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 356-57 (1963) (excluding loan companies from cluster market of loans and other financial services offered by commercial banks because, inter alia, loan companies' rates were generally higher).

9/ U.S. Anchor Mfg. v. Rule Indus., 7 F.3d 986, 997-98 (11th Cir. 1993)(market for generic and economy anchors excludes higher priced anchor), cert. denied, 114 S. Ct. 2710 (1994); United States v. Archer-Daniels-Midland Co., 866 F.2d 242, 246 (8th Cir. 1988) (high fructose corn syrup in separate market from sugar given 10-30% price premium), cert. denied, 493 U.S. 809 (1989); C.E. Servs. v. Control Data Corp., 759 F.2d 1241, 1246 (5th Cir. 1985) (price differential of 20-25% along with broader focus of services sufficient to exclude higher-priced service vendor).

10/ The defendants claim that the pricing evidence is unreliable because the items selected have been "cherry picked." Yet the items used were based on a sample that Staples' CEO Stemberg said was reliable, and Staples uses it to guide their everyday business decisions. PX 203 at 333; ; PX 3 at Tab B, D .

- Staples' own analysis of the effect of previously considered acquisitions confirms that they expect the merger will lead to higher prices;[11]

- Office Depot has been a particularly aggressive competitor, driving down costs and prices; in fact, competition between Staples and Office Depot often matters even more than the total number of competitors in the market and

- there will be a loss of potential competition where the two firms would have otherwise entered each other's or OfficeMax's territories.

Faced with this compelling evidence, defendants first argue that the office supply market is large and atomistic and that post-merger there will be dozens of competitive alternatives including mass merchandisers and contract stationers poised to take away business if Staples violates its well advertised promise to be competitive. But saying these alternatives are competitors does not mean they can effectively restrain a price increase. In support, the defendants present a handful of instances where these firms conducted price checks at Staples stores or consumers received price guarantees based on lower prices from these alternatives, together with statements from these retailers that they "compete." Isolated anecdotes cannot rebut the pricing evidence that shows these alternatives have little impact.

Since the facts are so unrewarding, defendants turn to the law and suggest that this is a "test case" in which the government has advanced "novel (and misguided) legal and economic theories in an attempt to overturn the status quo that has governed antitrust enforcement for the past generation." (DB at 5). To the contrary, the Supreme Court and the lower courts have

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[11]

held for decades that when a single firm acquires a significant market share through a merger, there is a substantial likelihood of competitive harm and the acquisition must be condemned under Section 7. Philadelphia Nat'l Bank, 374 U.S. at 363; PPG Indus., 798 F.2d at 1503. Merger law has always been about preventing mergers that have the potential of raising prices above competitive levels, whether by coordinated or unilateral action. Indeed, the Clayton Act talks about "tendency to monopoly" -- which certainly includes the concept of preventing those single concentrations of economic power that can lead to higher prices. "Unilateral effects" is nothing more than a fancy term used by economists to describe single firm market power, which has been a consistent concern of the antitrust laws. Community Publishers v. Donrey Corp., 892 F. Supp. 1146, 1168 (W.D. Ark. 1995); FTC v. Alliant Techsystems, 808 F. Supp. 9 (D.D.C. 1992); FTC v. Imo Indus., 1992-2 Trade Cas. (CCH) ¶ 69,943 (D.D.C. 1989); FTC v. Harbour Group Investments, 1990-2 Trade Cas. (CCH) ¶ 69,247 (D.D.C. 1990).

Finally, the defendants attempt to rebut the fact that this merger will result in a merger to monopoly or duopoly in scores of metropolitan markets by claiming the numbers are "phony." But this is hardly a case based solely on concentration analysis. Here, the defendants' pricing data and their own assessment of competition that reveals a unique competitive rivalry between Staples and the more aggressive Office Depot. FTC Brief at 27-30. Competition is the most fierce and prices are lowest where Staples and Office Depot meet head-to-head. The reason for this is simple. Staples and Office Depot have significant cost advantages over the only other competitor, OfficeMax. PX 46 at 0197; PX 206 at 138, 226; see also PX 196 at ¶ 4 (independents are at a cost disadvantage); PX 201 at ¶¶ 9-10, 14 (commercial dealers are at a cost disadvantage), Competition between lower cost firms drive prices down. If Staples and Office Depot merge, they will be able to raise prices above competitive levels because customers are unlikely to shift to less cost effective, higher priced firms in sufficient numbers to defeat an anticompetitive price increase. See Merger Guidelines, § 2.21 n.21.

III. BARRIERS TO ENTRY CONFIRM THE MERGED FIRM'S ABILITY TO EXERCISE MARKET POWER

Defendants claim that the FTC's case on entry "ignore[s] settled law and distort[s] the facts." DB at 35. But once again their brief and their evidence do not confront the reality that:

- in the past decade 20 of 23 office superstore firms have exited the market;
- there has been no new entry in the past several years;
- in numerous markets higher prices and profit margins have been profitably maintained without being eroded by new entry;
- a recent effort at repositioning resulted in a costly failure; and
- substantial and costly barriers face anyone seeking to open a competing chain of office superstores.

In evaluating the likelihood of entry, courts consider several factors including the costs of entry, distributional barriers, and special expertise. Perhaps the most critical factor is the history of entry, which is particularly probative in assessing the likelihood of future entry. See United States v. Baker Hughes, 908 F.2d 981, 988 (D.C. Cir. 1990) (two firms had entered within the past year and were poised for future expansion);[12] United States v. Waste

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[12] The defendants appear to want to suggest that the standards of the 1992 Merger Guidelines are somehow inconsistent with the case law, including Baker Hughes. This argument fails. Baker Hughes rejected the burden of demonstrating that entry would be "quick and effective" -- a standard that had not previously been articulated in either case law or guidelines. Unlike that standard, the 1992 Merger Guidelines deal with probabilities and (continued...)

Management, 743 F.2d 976, 982 (2d Cir. 1984) (history of recent entry indicated low entry barriers); United States v. United Tote, 768 F. Supp. 1064, 1076, 1080-82 (D. Del. 1991) (lack of entry supported finding of barriers); Calif. v. American Stores, 697 F. Supp. 1125, 1131-33 (C.D. Cal. 1988), aff'd in relevant part, 872 F.2d 837 (9th Cir. 1989), rev'd on other grounds, 495 U.S. 271 (1990); FTC v. Coca-Cola Co., 641 F. Supp. 1128, 1137 (D.D.C. 1986), vacated mem., 829 F.2d 191 (D.C. Cir. 1987). No firm has successfully entered the office superstore market in a decade. A score of unsuccessful entrants lie by the roadside, testament to the difficulties of entering this market.

In response, defendants claim that (1) the sole remaining superstore, OfficeMax, is opening new stores; (2) contract stationers are growing rapidly; and (3) existing mass retailers can enter through shelf-space expansion. None of these, even if they were true, would "likely avert anticompetitive effects from [the] acquisition." Baker Hughes, 908 F.2d at 989.

First, the fact that OfficeMax (or Staples for that matter) is opening other stores is not new entry.[13] The reality is that post-merger this market will be a duopoly. That one or both of the duopolists opens new stores does not suggest that an entirely new firm can establish a brand, acquire sufficient stores, form a distribution network, overcome saturation by

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[12](...continued)
not certainties and consistent with Baker Hughes accept the notion that a firm that is credibly threatening to enter may exert competitive pressure on pricing. It is not surprising that other courts have accepted the entry standard of the Merger Guidelines. Rebel Oil Co. v. Atlantic Richfield Co., 51 F.3d 1421, 1440 (9th Cir.), cert. denied, 116 S. Ct. 515 (1995).

[13] We agree that Staples, Office Depot and Office Max have been opening new stores at a rapid rate. That is why this merger will eliminate significant potential competition that would have led to lower prices in scores of new markets. This loss of potential competition is conveniently ignored by the defendants.

incumbents[14] and achieve multistore economies of scale, just to name a few of the barriers. FTC Brief at 33-34. Courts have repeatedly recognized these as formidable entry barriers.[15]

Second, expansion of contract stationers has little relevance to the question of entry. Entry is significant only if it is sufficient to avert the anticompetitive effects of a merger. As shown supra, contract stationers cannot constrain office superstore pricing and thus are not in the relevant product markets. Moreover, the expansion of these firms has come about primarily by acquisition of small independent stationers. Replacing scores of independent stationers with one contract stationer is not new entry.[16]

Finally, the defendants argue that product repositioning is possible, but the facts suggest otherwise. Mass merchandisers play a small role in the office supply market. The only one which tried to expand its role -- Best Buy -- found the experience costly. FTC Brief at 37. No other firm seems poised to make the same mistake, and the defendants have identified any.[17]

14/ Defendants seek to walk away from their saturation studies DB at 37 n.26. these studies are surely reliable in assisting the court in making a prediction about the likelihood of future entry.

15/ American Stores, 872 F.2d at 843 (multistore economies of scale such as advertising costs); Bon-Ton Stores v. May Dep't Stores Co., 881 F. Supp. 860, 876 (W.D.N.Y. 1994) (difficulties in finding adequate sites); see also FTC v. Warner Communications, 742 F.2d 1156, 1163-64 (9th Cir. 1984) (need for national scale for successful distribution); Tasty Baking Co., 653 F. Supp. at 1263 (high costs to build bakeries, develop brand recognition, and establish routes with favorable retailer participation).

16/ Defendants also argue that entry is easy by pointing to the growth of Dell and Gateway. Of course, for a manufacturer to sell computers directly to consumers has nothing to do with the feasibility of selling office supplies, such as a paper clips, staples, and writing pads through the same channel.

17/ Defendants argue that the FTC is alleging that aggressive competition is itself a (continued...)

IV. DEFENDANTS' ALLEGED EFFICIENCIES ARE UNVERIFIED, NOT MERGER SPECIFIC AND UNLIKELY TO REVERSE THE MERGER'S ANTICOMPETITIVE EFFECTS

Given the strong evidence of likely anticompetitive effects, defendants have resorted to cost savings claims as the silver bullet saving this transaction. Although this argument takes up almost a quarter of their brief, it is deficient on several critical issues:

- the speculative evidentiary basis for the claimed cost savings, which are almost five times what Staples and Office Depot told their respective boards, their shareholders, and the investment community;
- the most significant cost savings can be achieved through internal growth; and
- the lack of evidence that sufficient savings will be passed on to consumers to offset the likely price increase in the absence of competitive rivalry -- the driving force both to achieve cost savings and to pass them on.

Competition is the driving force behind efficiency. Without competition there can be no assurance that consumers will receive the benefits that the market can produce.[18/] Efficiency claims are easier to assert than to achieve,[19/] which is why the courts impose a "very rigorous" evidentiary burden on efficiency claims. United States v. Rockford Mem. Corp., 717 F. Supp.

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[17](...continued)
barrier to entry, citing United States v. Syufy Enters., 903 F.2d 659, 668 (9th Cir. 1990). Nothing could be farther from the truth. Not only are there extensive barriers to entry in this market, but Staples' pricing behavior is directly contrary to the aggressive competitor described in Syufy that "eschews monopoly profits."

[18]/ That is why the courts and the antitrust agencies agree that efficiencies cannot justify a merger to monopoly or near monopoly. FTC Brief at 40 & n.36.

[19]/ Indeed, some studies show that firms often fail to accomplish the projected cost savings from a merger. See generally, Brodley, "Proof of Efficiencies in Mergers and Joint Ventures," 64 Antitrust L.J. 576 (1996).

1251, 1289 (N.D. Ill. 1989), aff'd, 898 F.2d 1278 (7th Cir.), cert. denied, 498 U.S. 920 (1990); see FTC v. University Health, 938 F.2d 1206, 1222-23 (11th Cir. 1991). Specifically, defendants must prove, with "clear and convincing evidence," Rockford, 717 F. Supp. at 1289, that claimed efficiencies:

(1) are identified with precision, are not based on "speculation" and actually will be achieved, University Health, 938 F.2d at 1223; United States v. Mercy Health Services, 902 F. Supp. 968, 987-88 (N.D. Iowa 1995);

(2) are "merger-specific," i.e., they cannot be achieved by other means less restrictive of competition, Mercy Health, 902 F. Supp. at 987, n.4; United States v. Ivaco, 704 F. Supp. 1409, 1425 (D. Mich. 1989); Rockford, supra;

(3) are specific to the market at issue, Philadelphia National Bank, 374 U.S. at 370-71; Ivaco, 704 F. Supp. at 1425-27; Rockford, supra;

(4) will improve competition, i.e., do not simply transfer wealth from one party to another;

(5) will be passed on, and produce a significant economic benefit to consumers, United Tote, 768 F. Supp. at 1084-85 (efficiencies rejected because "there are no guarantees that these savings will be passed on to the consuming public"); American Stores, 697 F. Supp. at 1133 (rejecting claim of over $50 million in efficiencies since savings will not "invariably" be passed on to consumers); and

(6) will outweigh the anticompetitive effects of the acquisition and result in a more competitive market. University Health, 938 F.2d at 1222-23 ("significant economies and that these economies ultimately would benefit competition, and hence, consumers."); Ivaco, supra; United Tote, supra.

Defendants' efficiency claims fall far short of meeting any of these requirements. The cost savings are neither well verified or established with precision. Defendants basically rely on projections and estimates in their "Efficiency Book" project, whose goal was staving off litigation,[20] not convincing investors that the merger was efficient, and on lawyer-crafted form

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[20] -

(continued...)

"statements" from vendors, few of which provide specifics about cost savings. Their alleged cost savings multiplied repeatedly during the course of the Commission's investigation and continued to grow even within the four corners of their brief – from $3 - 5 billion (page 3) to $4.9 - 6.5 billion (page 23). The self-styled "conservative case" cost savings today are almost times the amount presented to the boards of both companies when they approved the merger.[21] These after-the-fact generated estimates of cost savings should be given little weight "because of the relatively little attention placed by the defendants in planning for and agreeing upon the merger." Rockford, 717 F. Supp. at 1289.

In addition, the alleged costs savings are based on a number of unproven assumptions and undocumented claims. For example, alleged product cost savings were based on guesses and assumptions by Staples that were never vetted with vendors. The 40 or so "statements" from vendors are mostly letters attesting simply to the fact that some unspecified savings "might be realized."[22]

Ultimately, the basis for these claims is defendants' assertion that they "surely have the best knowledge of their own business; they are confident that they can achieve the substantial efficiencies . . . ." DB at 27. But "trust me" is not the standard of proof adopted by the courts.

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[20](...continued)

[21]/ The efficiency claims were also inconsistent with the defendants' Joint Proxy Statement filed in January 1997. PX 274 (Staples' SEC proxy statement describes Goldman Sachs forecasts as the "best currently available estimates and judgments" on efficiencies).

[22]/ The defendants' also assume that all of these costs savings will reoccur year after year. But there is no evidence that even if Staples could secure initial costs savings that they could secure an identical rate of cost reductions each year.

See University Health, 938 F.2d at 1223 ("defendant [cannot] overcome a presumption of illegality based solely on speculative, self-serving assertions"); see Mercy Health, 902 F. Supp. at 989 (rejecting claims because of "lack of evidence . . . as to their actual ability to implement proposed efficiencies"). It is certainly not the approach to take here where the alleged savings keep escalating without adequate analysis.

Moreover, the court should be cautious about justifying a merger based on greater buying power. Certainly greater buying power could justify any merger including Staples acquisition of Office Max. But such an argument has no logical endpoint; it would permit a merger to monopoly.[23/]

Many of the remaining alleged savings should be rejected because they are not "merger-specific," i.e, they can be achieved by alternative means less restrictive of competition. FTC Brief at 41-42. Both Office Depot and Staples are growing at a tremendous rate, opening scores of new stores each year. Many of the savings claimed by the parties, including the product cost savings -- which account for percent of the alleged cost savings -- could be achieved through this internal expansion or the acquisition of other office supply firms. We will demonstrate at trial that the vast majority of these savings could be achieved through internal growth.

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[23]/ Another reason to discount cost savings from increased buying power is that they will not necessarily result in improved productive efficiency. Many commentators have suggested that an efficiency defense not recognize cost savings which do not involve an improvement in efficiency, but merely represent a wealth transfer of money from one party to another. Brodley, supra at 581-82; Rogers, "The Limited Case for an Efficiency Defense in Horizonal Mergers," 58 Tulane L.R. 503, 520 (1983); Areeda & Turner, IV Antitrust Law ¶ 957 (1980). For example, in FTC v. Procter & Gamble Co., 386 U.S. 568, 604 (1967), Justice Harlan, in concurring, rejected "efficiencies" from reductions in advertising costs that the merged firm could extract using its increased bargaining power, because P&G did not demonstrate that costs savings would lead to more "efficient marketing techniques."

Other suspect claims are alleged savings based on the merged firm adopting both firms' "best practices." The courts have been particularly critical of best practice claims, recognizing that there are far less anticompetitive means for firms to improve their practices than through an anticompetitive merger. See Mercy Health, 902 F. Supp. at 988; Rockford, 717 F. Supp. at 1290-91; see Brodley, supra at 582.

The defendants estimate significant savings in reducing marketing costs. But not all of these savings should be recognized. Potential costs savings from what are in effect reductions in competition are not cognizable efficiencies. Cf. Rockford, 717 F. Supp. at 1290 (rejecting efficiency claims that did not lead to increased production); see Alliant Techsystems, 808 F. Supp. at 23 (elimination of "inefficiencies" of competitive bid were not cognizable); cf. Hovenkamp, Federal Antitrust Policy, § 12.2b, n.24 (1994)("qualifying efficiency cannot be elimination of the cost of competing, or virtually all mergers to monopoly would qualify for the defense.").

Over   percent of the alleged cost savings consists of savings for products outside the office supply consumable market. Procurement savings for goods such as book cases, computers, and office furniture will not effect the level of competition in the office supply consumable market. Savings outside the market are irrelevant because "anticompetitive effects of an acquisition in one market cannot be justified by procompetitive effects in another market." Philadelphia National Bank, 374 U.S. at 370-71.

Ultimately, even if these cost savings claims were verified, substantial, and merger-specific, a key question remains. Once Office Depot -- the most efficient and aggressive competitor -- is eliminated, can consumers rely on the good intentions of the dominant firm to lower prices as much as they would have with Office Depot still in the market? We think not.

Today, in markets where Staples does not face Office Depot, its prices and profits are higher, because it is free to be more selective about passing on cost savings. See infra at 9. Thus, any notion that post-merger Staples will generously pass on almost all of the alleged cost savings, once the disciplining force of Office Depot is gone, is belied by Staples' current conduct in markets where Office Depot does not compete.

The defendants must demonstrate that the cost savings will outweigh the acquisition's likely anticompetitive effect and lead to a more competitive market. Their late-blossoming, litigation-driven speculative estimates cannot meet that burden.

V. NOTHING LESS THAN A FULL-STOP INJUNCTION WILL PROTECT COMPETITION HERE

A. Section 13(b) only requires the Commission to raise serious, substantial questions

Although defendants seek to portray the test for awarding a preliminary injunction as especially demanding, in fact every appellate court addressing the question has held that the Commission satisfies the "likelihood of success" prong of Section 13(b) if it demonstrates "questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals," University Health, 938 F.2d at 1218 (quoting Warner Communications, 742 F.2d at 1162, quoting FTC v. National Tea Co., 603 F.2d 694, 698 (8th Cir. 1979)); see FTC v. Freeman Hosp. Corp., 69 F.3d 260, 267 (8th Cir. 1995).[24] This standard acknowledges that Congress, by the express terms of Section 13(b), reserved resolution of the merits of merger challenges to the Commission, leaving to the courts the responsibility to award interim relief that preserves the viability of the administrative proceeding after assuring themselves that the Commission's proof does raise appropriately substantial "questions going to the merits." Although the Commission's proof will satisfy any reasonable formulation of the test for preliminary injunctive relief, we believe that the standard repeated in the appellate caselaw is the proper one, and is particularly appropriate in the context of an antitrust preliminary injunction proceeding that spans only seven weeks from complaint to hearing and cannot possibly replicate the trial on the merits. Chicago Prof. Sports L.P. v. NBA, 961 F.2d 667, 676 (7th Cir.) ("seven weeks from complaint to trial is unheard of in antitrust litigation. . . . If litigation ought not to resemble a marathon, neither is the 100-yard dash a good model."), cert. denied, 506 U.S. 954 (1992).[25]

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[24] This is also the standard adopted in the memorandum opinion of August 2, 1978, in FTC v. Beatrice Foods Co., 587 F.2d 1225 (D.C. Cir. 1978). We agree that, although it is reprinted in F.2d, the opinion is technically "unpublished." However, defendants' contention that the opinion was permanently vacated is incorrect; the panel expressly reinstated its opinion following the denial of rehearing en banc, 587 F.2d at 1238, and the opinion is listed in F.2d as having disposed of the case. See 580 F.2d 701 (1978). Ironically, defendants rely heavily for their statement of the applicable standard, and passim throughout their memorandum, upon a district court decision that was itself vacated, FTC v. Occidental Petroleum Corp., 1986-1 Trade Cas. (CCH) ¶ 67,071 (D.D.C. Apr. 29, 1986), vacated, No. 86-5254 (D.C. Cir. Oct. 23, 1986), without informing this Court of that fact.

[25] The defendants' proposal to impose a "heavy burden" on the government is inconsistent with the purposes of Section 7 of the Clayton Act which seeks to stop anticompetitive mergers in their incipiency. California v. American Stores Co., 495 U.S. 271, 284 (1990) (a "plaintiff need only prove that [the acquisition's] effect 'may be substantially to lessen competition.'") (emphasis in original). While requiring more than mere "ephemeral possibilities," Congress used the words "may be" to indicate certainties (continued...)

B. The facts of this case mandate injunctive relief

Having found that the Commission has raised serious and substantial questions about the legality of this proposed merger under Section 7, the D.C. Circuit has "consistently held . . . that there is a 'presumption in favor of a preliminary injunction.'" Alliant Techsystems, 808 F. Supp. at 22-23 (quoting PPG Indus., 798 F.2d at 1507). Defendants thus face a "difficult task in justifying anything less than a full stop injunction." PPG Indus., 798 F.2d at 1506; Consolidated Gold Fields PLC v. Minorco, S.A., 871 F.2d 252, 261 (2d Cir.)(a "preliminary injunction is therefore the remedy of choice for preventing an unlawful merger."), cert. denied, 492 U.S. 939 (1989).

Defendants claim that the public equities are on their side, citing their efficiency claims and the merged firm's alleged expansion plans. We have already shown that the efficiencies claims are tenuous and do not justify a merger to monopoly. As for expansion plans, far from "leading to any great expansion," this merger has led to the loss of future competition, as Staples and Office Depot have scaled back their plans to enter into each other's areas as well as new areas. FTC Brief at 29-32. Although defendants also claim that this merger will allow them

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[25](...continued)
were not required. Brown Shoe Co. v. United States, 370 U.S. 294, 323 (1962). Thus, Section 7 does not require "a certainty" or "even a high probability" that an acquisition will substantially lessen competition. FTC v. Elders Grain, 868 F.2d 901, 906 (7th Cir. 1989). As Judge Posner has explained the statute "requires a prediction and doubts are to be resolved against the transaction." Id. at 906.

The defendants also suggest that a "preliminary injunction is always 'an extraordinary and drastic remedy,'" quoting FTC v. Exxon Corp., 636 F.2d 1336, 1343 (D.C. Cir. 1980). Of course, the court in Exxon said nothing about preliminary relief always being extraordinary. As discussed infra, once the FTC raises serious and substantial questions, a full stop injunction is the appropriate remedy.

to speed plans to enter into foreign markets, such out-of-market considerations should not be considered as a valid equity against an injunction. Imo Indus., 1992-2 Trade Cas. (CCH) ¶ 69,943, at 68,559-60 (preliminarily enjoining merger despite claim that the merger could "create a stronger, more competitive market in third generation products" and thus be ultimately beneficial to a strong national defense).

Finally, defendants cite private equities, primarily the loss of money to stockholders of Staples and Office Depot. Although private equities may be considered, "[t]he principal equity weighing in favor of issuance of the injunction is the public's interest in effective enforcement of the antitrust laws." University Health, 938 F.2d at 1225. In particular, as Judge Bork has written, courts may "not rank as a private equity meriting weight a mere expectation of private gain from a transaction the FTC has shown is likely to violate the antitrust laws." PPG Indus., 798 F.2d at 1507 (rejecting possibility there might be no more attractive offers for the acquired firm as a potential equity); Laidlaw Acquisition Corp. v. Mayflower Group, 636 F. Supp. 1513, 1521 (S.D. Ind. 1986) (neither the bidder, nor shareholders of target "are entitled to any gain obtained from a sale that presents a substantial likelihood of violating the Clayton Act.").

Furthermore, both Staples and Office Depot are profitable and robust. There is every reason to expect that Office Depot, the low-price aggressive maverick in this market, would continue generating sales volume and turning a substantial profit in the future.

Despite strong equities in favor of an injunction as well as serious concerns about interim anticompetitive harm,[26] defendants contend that an injunction is nevertheless unnecessary

[26] Defendants also try to rebut the potential for interim anticompetitive harm by promising to change their tune and lower prices. But their claim ignores the loss of the new (continued...)

because unscrambling the eggs following an administrative trial will be easy. DB at 44. Defendants analogize Office Depot to a "free standing plant" that could easily be divested post-merger. Defendants are wrong both as a matter of law and fact. The inadequacy of post-merger divestiture has been recognized countless times both by courts and commentators. FTC Brief at 43-44.[27] Moreover, the interdependent nature of Office Depot's operations and the fragility of its public image -- the two most critical factors in a retailing operations' success -- differentiate it from a free-standing industrial plant. First, defendants' operations are complex entities that combine the carefully thought-out retail format of an office superstore with an intricate web of distribution that guarantees that consumers shopping in those stores will in fact experience that format. PX 5 at 3-4; PX 6 at 8-9. Remove any part of this elaborate foundation standing behind these stores, and they will rapidly lose their competitive value.

This move will undermine the competitive viability of Office Depot's network of stores. Defendants will also change the name

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[26](...continued)
competition that would have occurred as Staples and Office Depot entered new markets and opened new stores. Before the merger, Office Depot aggressively expanded into Staples' territory. FTC Brief at 29-32. Now, Office Depot has put future expansions on "hold." PX 213 at 208-09; This Circuit has specifically warned against denial of a preliminary injunction where there is evidence that "the acquired company was planning prior to the acquisition to embark on a new procompetitive venture." FTC v. Weyerhaeuser Co., 665 F.2d 1072, 1086 (D.C. Cir. 1987).

[27]/ FTC v. Lancaster Colony Corp., 434 F. Supp. 1088, 1096 (S.D.N.Y. 1977) ("[a]t best, divestiture is a slow, cumbersome, difficult, disruptive and complex remedy."); Consolidated Gold Fields v. Anglo American Corp., 713 F. Supp. 1457, 1469 (S.D.N.Y. 1989) (although equities favor lifting preliminary injunction, court refused to do so out of concern that hold separate order will not check interim anticompetitive harm and safeguard eventual relief).

of the Office Depot stores, destroying the unique image that Office Depot's name has developed with its loyal consumers. They have also announced plans to consolidate distribution centers that cannot easily be separated later. At the end of the trial, there is every reason to fear that what will remain of Office Depot will be a pale chimera of its former self -- a shrunken group of stores shorn of its brand name and stripped of its independent distribution system -- that no one will want to buy. Thus, denying the injunction risks ceding the market to Staples even if the acquisition is ultimately determined to violate Section 7.

In sum, once the court has found that the Commission has met its burden under § 13(b), the equities, the possibility of interim anticompetitive harm, and the safeguarding of ultimate relief all strongly support the issuance of a preliminary injunction.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this day of May 9, 1997, I caused a copy of the public version of Plaintiff's Reply to Defendants' Memorandum of Law in Opposition to the Federal Trade Commission's Motion for a Preliminary Injunction to be served by fax upon the following persons.

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