

FTC Decision Highlights Growing Divide On Vertical Mergers

By Daniel Hemli and Jacqueline Java

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The past couple of years have seen an increase in large “vertical” mergers, combinations of businesses operating within the same industry but at different levels of the supply chain. Some of the most high profile include AT&T Inc./Time Warner Cable, Cigna/Express Scripts, and CVS Pharmacy/Aetna Inc. A recent Federal Trade Commission enforcement action involving a vertical merger between Staples Inc. and Essendant Inc. has highlighted the intensifying debate regarding the competitive benefits and harms resulting from vertical integration, as well as starkly divergent views between individual commissioners over various aspects of merger review. This has practical consequences for companies considering such transactions, including a likelihood of more and longer investigations for certain types of deals.

On Jan. 28, 2019, the FTC announced a settlement resolving competitive concerns relating to the \$483 million acquisition by Staples, the largest retailer of office products in the United States, of Essendant, the largest U.S. wholesale distributor of office products. Essendant is one of only two U.S. wholesalers supplying a wide assortment of office products nationwide to independent commercial dealers and resellers, which in turn sell to mid-sized business customers. Staples, which is owned by Sycamore Partners, a private equity fund, sells office supplies directly to mid-sized businesses in competition with Essendant’s dealer customers. Thus, for the most part, Staples and Essendant do not compete with each other; rather, Staples competes with Essendant’s customers.

Following an investigation by FTC staff, the commission voted 3-2 to accept a settlement to resolve a concern that, post-merger, Staples would gain access to commercially sensitive business information about Essendant’s dealer customers and the end customers of those dealers, which could allow Staples to offer higher prices than it otherwise would when bidding against a dealer for an end customer’s business. The proposed settlement order imposes “behavioral” remedies, including firewalls to limit whom within Staples will have access to commercially sensitive information of dealers who buy from Essendant and data regarding the end customers of those dealers. The order also provides for the appointment of a monitor for 10 years, among other requirements.



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The three Republican FTC commissioners — Chairman Joseph Simons and Commissioners Noah Phillips and Christine Wilson — voted in favor of the settlement, while the two Democratic commissioners — Rebecca Slaughter and Rohit Chopra — dissented. Significantly, not only did the commissioners disagree on the appropriate outcome for this specific transaction; the commissioners also used this case as an opportunity to air their individual views on vertical mergers more generally, as well as other issues relating to merger enforcement.

With regard to the Staples/Essendant transaction itself, commissioners Chopra and Slaughter found that Sycamore (Staples' owner) would have a strong incentive to raise Essendant's prices to dealers that compete with Staples, thereby harming those dealers by raising their costs or forcing them to raise prices to their business customers. Chopra, in his dissenting statement, also expressed concern that the combined entity could exercise increased market power on the buy side, "monopsony power," in purchasing office supply products from manufacturers or other suppliers. He also stressed the importance of considering the specific buyer's incentives and track record, emphasizing Sycamore's investment approach in a previous transaction (in which it acquired certain assets and quickly resold those assets) as support for the notion that Sycamore would be more likely to focus on rapidly increasing margins and less likely to invest substantial capital to grow and nurture Essendant's business.

The three commissioner majority strongly disagreed on all of these points, finding that the evidence gathered from staff's thorough investigation did not support these theories of competitive harm. On the "raising rivals' costs" theory, the majority concluded that if Sycamore tried to raise Essendant's prices to dealers, many of those dealers would switch to Essendant's largest wholesaler competitor, S.P. Richards Co., and that even if some dealers tried to pass on those price increases, their business customers would not likely switch to Staples, hence such a strategy would not be profitable for Sycamore. On the monopsony theory, the majority agreed that the merger would lower the combined entity's purchasing costs, but it determined that those cost savings were in fact procompetitive and not the result of an increase in Staples' buyer market power. The majority thus reached opposite legal conclusions based on the same evidential record. The majority also gave short shrift to Chopra's views about Sycamore as a buyer, alluding to Chopra's "negative view of private equity" and stating that "the application of that general view to the facts of this case does not raise a cognizable antitrust concern."

The commissioners did not stop there, however. Slaughter devoted most of her dissenting statement to a discussion of vertical merger enforcement generally, noting that she is "particularly concerned that the current approach to vertical integration has led to substantial under-enforcement." After describing various ways in which vertical mergers, particularly those involving highly concentrated markets, can harm competition, Slaughter proposed that in close cases where the FTC has meaningful concerns but has not mustered sufficient evidence to justify a court challenge, it should commit to a follow-up retrospective investigation a few years after the merger is consummated; if such a retrospective identifies actual anticompetitive effects, the FTC should then bring an enforcement action to break up the merger.

Wilson, as part of the majority, issued her own statement directly contradicting the two Democratic commissioners and expressing "grave concerns about my dissenting colleagues' enthusiasm for treating all vertical mergers with skepticism and conducting a fundamental reevaluation of our vertical merger policy." Instead, Wilson explained that "integrating operations at different levels of production often yields clear economic benefits," leading to her conclusion that "there are very few vertical mergers that should be challenged."

On the topic of merger retrospectives, the majority expressed support for expanding the FTC's merger retrospective program to analyze and learn from prior enforcement decisions. However, it characterized Slaughter's proposal as unrealistic given the FTC's finite resources. Wilson also expressed doubt about "clearing mergers with remedies, after extensive investigations, while simultaneously threatening to undo those mergers later," noting that such a policy would create uncertainty that is "bad for both businesses and their consumers."

There are a number of important takeaways from the FTC's decision in Staples/Essendant:

- The antitrust agencies are continuing to carefully review vertical mergers, despite the U.S. Department of Justice Antitrust Division's much-publicized unsuccessful challenge to the recent AT&T/Time Warner merger (which is currently awaiting a decision on appeal).
- There is intense disagreement between the sitting FTC commissioners regarding the competitive pros and cons of vertical integration. This reflects the complexity of vertical merger analysis and can cause investigations of vertical transactions to take longer than those lacking a vertical component, even for deals that are ultimately cleared.
- The divergence of views at the FTC adds uncertainty to an area of merger enforcement that was already muddled over the past year when Assistant Attorney General Makan Delrahim, who heads the DOJ's Antitrust Division, expressed significant skepticism of behavioral remedies for vertical deals and stated a strong preference for structural relief, such as asset divestitures, which historically has been used mostly in horizontal mergers of competitors. In that regard, the majority's statement in Staples/Essendant notes that "structural remedies are usually preferred but not always essential." Despite the decision in Staples/Essendant, companies considering a vertical tie-up should not assume that any competitive concerns can be resolved solely with behavioral remedies.
- The differences of opinion among the FTC commissioners appear to extend to other areas of merger enforcement and are illustrative of a broader and growing debate about whether allegedly lax antitrust enforcement has led to historic levels of concentration in some sectors of the economy, and whether this justifies sweeping changes to antitrust policy, including merger analysis. The FTC is currently conducting a series of public hearings on these issues.

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