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Stepping out in an Old Brown Shoe: In Qualified Praise of Submarkets

Jonathan Baker

STEPPING OUT IN AN OLD *BROWN SHOE*: IN QUALIFIED PRAISE OF SUBMARKETS†

JONATHAN B. BAKER*

One of the most widely cited paragraphs in the Supreme Court's 1962 *Brown Shoe* decision sets forth seven "practical indicia" for defining "submarkets."[1] Since that time, lower courts frequently have relied upon the *Brown Shoe* factors as authority when defining antitrust markets. Yet commentators are often highly critical when they do so.

This essay argues that the attraction of the *Brown Shoe* practical indicia to the courts and the problems commentators recognize in their application arise from the same source. A single analytical approach—the use of practical indicia to identify submarkets—has been employed to address four concepts: buyer substitution, seller substitution, unilateral competitive effects of mergers among sellers of differentiated products, and price discrimination markets. As antitrust has come to a better understanding of these four economic concepts, it has become clear that they are more effectively treated in separate analyses, as is done in the DOJ and FTC Horizontal Merger Guidelines.[2]

While the concepts of buyer and seller substitution are well understood today, the latter two ideas, unilateral competitive effects and price discrimination markets, were largely inchoate in legal commentary in 1962 and have only recently begun to be recognized and considered by the courts. *Brown Shoe* can help judges address these more novel ideas by providing lower courts with legal authority for recognizing the contemporary economic concepts of unilateral competitive effects and price dis-

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† For those readers closer in age to my students than to me: *cf.* Beatles, *Old Brown Shoe*, <http://top40gold.com/artist/beatles/Beatles_OldBrownShoe.html> ("Now I'm stepping out this old brown shoe, Baby I'm in love with you").

* Associate Professor, Washington College of Law, American University, Washington, D.C. The author is indebted to Richard Brunell for thoughtful comments and to David Turchi for research assistance.

[1] Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962).

[2] U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992, as amended 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶13,104 [hereinafter 1992 Merger Guidelines].

crimination markets. But with respect to unilateral competitive effects, this approach may be only a temporary expedient, awaiting more complete adaptation of antitrust doctrine to the rich economic analysis suggested by the Merger Guidelines.

To understand the uses and abuses of *Brown Shoe* submarkets, it is useful to begin by reviewing the key *Brown Shoe* paragraph:

> The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it. However, within this broad market, well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes. The boundaries of such a submarket may be determined by examining such practical indicia as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors. Because § 7 of the Clayton Act prohibits any merger which may substantially lessen competition "in *any* line of commerce" (emphasis supplied), it is necessary to examine the effects of a merger in each such economically significant submarket to determine if there is a reasonable probability that the merger will substantially lessen competition. If such a probability is found to exist, the merger is proscribed.[3]

The first sentence is unremarkable. It recounts that the "outer boundaries" of a product market are to be determined using two familiar legal tests related to buyer substitution: "reasonable interchangeability of use or the cross-elasticity of demand."[4] The Merger Guidelines' approach to market definition—evaluating whether the collection of products and locations would make a valuable monopoly, given the possibility of buyer substitution[5]—is a refinement of these two tests.[6] The next sentences in the *Brown Shoe* paragraph, which recognize the concept of submarkets

[3] *Brown Shoe*, 370 U.S. at 325 (footnotes and citation omitted).

[4] A footnote to the first sentence (omitted from the quotation above) suggests that the cross-elasticity of production facilities may also be an important factor in market definition. This too is unremarkable, though the Merger Guidelines take the possibility of seller substitution into account in a different way than was proposed in *Brown Shoe*. *See generally* Jonathan B. Baker, *The Problem with* Baker Hughes *and* Syufy: *On the Role of Entry in Merger Analysis*, 65 ANTITRUST L.J. 353 (1997).

[5] The Merger Guidelines define a market as "a product or or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a 'small but significant and nontransitory' increase in price, assuming the terms of sale of all other products are held constant." 1992 Merger Guidelines, *supra* note 2, § 1.

[6] On the history of market definition, see generally Gregory J. Werden, *The History of Antitrust Market Delineation*, 76 MARQ. L. REV. 123 (1992).

and set forth seven factors for identifying them, are the main source of controversy.

I. SUBSTITUTION IN DEMAND AND SUPPLY

Some of the seven practical indicia appear related to the identification of buyer substitution patterns, the concern of market definition under the Merger Guidelines. Sensitivity to price changes, for example, could be interpreted as suggesting a method of estimating demand cross-elasticities. Industry recognition of the submarket as a separate economic entity could suggest inferring buyer behavior from indirect evidence: the views of and actions taken by sellers, who have an economic interest in understanding buyer substitution patterns. The product's peculiar characteristics and uses, distinct customers, distinct prices, and specialized vendors, might suggest gaps in the chain of substitutes, and thus also permit inferences about likely buyer substitution patterns. These types of evidence vary in their probative value,[7] and are not necessarily the only evidence that can be brought to bear,[8] but they could all reasonably be read to suggest an inquiry into buyer substitution.

Another factor in the list of practical indicia, unique production facilities, appears related to the identification of seller substitution patterns. Two other factors, industry recognition of the submarket as a separate economic entity and peculiar product characteristics, might also be related to the flexibility of seller production. This economic force, a type of entry, must be recognized in antitrust analysis because it could discipline the exercise of market power. Some courts have accounted for seller substitution possibilities through market definition, but the Merger Guidelines do so through the identification of market participants (if seller substitution would occur quickly and with little sunk expenditures) or through the analysis of entry.[9]

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[7] For example, using distinct prices to define markets could lead a court improperly to exclude the possibility that a high-price, high-quality product was a close substitute for a low-price, low-quality product. On the other hand, when quality is related to price, price classes may provide useful shorthand for describing collections of products properly defining a market. *E.g.*, United States v. Gillette Co., 828 F. Supp. 78 (D.D.C. 1993) (defining "premium" writing instrument market for pens sold in the $50 to $400 range).

[8] Most notably, the list omits a common approach of the federal enforcement agencies to implementing the market definition concept of the Merger Guidelines—learning about buyer substitution patterns by interviewing customers about their likely response to a price increase by a hypothetical seller monopolist—unless the reference to public recognition of the submarket as a separate economic entity is interpreted as suggesting this approach.

[9] *See generally* Baker, *supra* note 4. In the Merger Guidelines, entrants capable of providing new competition quickly and with little sunk expenditures (termed "uncommitted" entrants) are assigned market shares based on their divertible capacity. All other entry possibilities ("committed" entrants) are assessed for timeliness, likelihood, and sufficiency.

Used in this way, the *Brown Shoe* practical indicia can be interpreted as "evidentiary proxies for direct proof of substitutability" in demand and supply (or "as proxies for cross-elasticities"), which is how they were treated in *Rothery*, a D.C. Circuit opinion written by Judge Robert Bork.[10] Had the *Brown Shoe* factors exclusively been applied as proxies for substitutability, they would not have drawn sharp criticism from commentators.

The main concern of the critics is that the practical indicia sometimes have been applied blindly, without reference to the goals of identifying buyer and seller substitution possibilities.[11] Blind application allowed courts to define inappropriately narrow submarkets within the outer bounds of markets properly defined with reference to substitution possibilities.[12] In consequence, courts improperly identified market power in situations where the firms were in fact competing vigorously.[13] According to Professors Gellhorn and Kovacic, "[T]he submarket concept too often served as an irresistible tool for courts and enforcement agencies to gerrymander markets to achieve preferred outcomes."[14] The commentary critical of the *Brown Shoe* approach to market definition resolved itself into a slogan: there are no submarkets, only markets.[15] This slogan sought to discourage courts from delineating unduly narrow entities as relevant antitrust markets by relating the *Brown Shoe* practical indicia to

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[10] Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210, 218 & n.4, 219 (D.C. Cir. 1986) (Bork, J.).

[11] *See* Lawrence C. Maisel, *Submarkets in Merger and Monopolization Cases*, 72 GEO. L. REV. 39, 44 n.30 (1983); *cf.* David A. Clanton, *Focusing the Inquiry: Specificity in the Merger Guidelines and Elsewhere*, 71 CAL. L. REV. 430, 439 (1983) (commending 1982 Merger Guidelines for presenting a model of market definition that explains the relevance of each factor, in contrast with the "laundry list" of factors set forth in *Brown Shoe*).

[12] The concept of submarkets has been applied to market definition under the Sherman Act as well as in merger analysis. *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE § 3.2c, at 88 & n.12, 89 (2d ed. 1999).

[13] *See generally* ABA ANTITRUST SECTION, MONOGRAPH NO. 12, HORIZONTAL MERGERS: LAW AND POLICY 128–29 (1986); 2A PHILLIP E. AREEDA ET AL., ANTITRUST LAW ¶ 533 (1995); ERNEST GELLHORN & WILLIAM E. KOVACIC, ANTITRUST LAW AND ECONOMICS 377–79, 402–03 (4th ed. 1994); RICHARD POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 129 (1976); James A. Keyte, *Market Definition and Differentiated Products: The Need for a Workable Standard*, 63 ANTITRUST L.J. 697, 699 (1995); Maisel, *supra* note 11; *Panel Discussion: The New Merger Guidelines*, 51 ANTITRUST L.J. 317, 321 (remarks of William F. Baxter), 328–29 (remarks of Donald F. Turner) (1982). *Cf.* Werden, *supra* note 6, at 160–61 (collecting commentary to demonstrate that the submarket concept "was not well received by most commentators" in the wake of *Brown Shoe*).

[14] GELLHORN & KOVACIC, *supra* note 13, at 378.

[15] *See, e.g.*, H.J., Inc. v. International Tel. & Tel. Corp., 867 F.2d 1531, 1540 (8th Cir. 1989) (the "same proof" establishes the existence of a product market and a product submarket); White & White, Inc. v. American Hosp. Supply Corp., 723 F.2d 495, 500 (6th Cir. 1983) ("a submarket is a market"). Recent commentary accepts that submarkets should be defined using the same criteria as markets. *See, e.g.*, 2A AREEDA ET AL., *supra* note 13, ¶ 533c; HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY § 3.2c (2d ed. 1999).

the analysis of buyer and seller substitution possibilities employed in market definition.

To the extent this slogan suggests that when a broad aggregation of products constitutes a market, a narrower collection cannot also do so, it misleads. For example, it is plausible that a monopolist of all beverages would find a price increase profitable, and thus "beverages" would constitute a product market. That observation would not preclude the possibility that a monopolist of all carbonated soft drinks would find a price rise profitable, and thus that "carbonated soft drinks" would constitute a product market, or the possibility that "cola-flavored soft drinks" would also simultaneously constitute a product market, all defined based on familiar criteria involving buyer substitution.[16] Although a court might often focus its concern and analysis on the smallest such market, as the Merger Guidelines "generally" recommend,[17] a court is entitled to identify a violation of the antitrust laws based on harmful effects in any market, even one that is not the smallest.[18] Doing so does not undermine the economic point of market definition if all such markets, whether broad or narrow, are defined with reference to substitution possibilities, as through the Merger Guidelines methodology.

There should be little controversy about the *Brown Shoe* practical indicia to the extent they are used as proxies for demand and supply substitutability. Courts have also used the practical indicia, and the submarkets they define, as basis for recognizing two other important economic concepts also found in the Merger Guidelines: price discrimination markets and the unilateral competitive effects of mergers among sellers of differentiated products. Application of the submarket concept to price discrimination markets should also not be controversial, as will be discussed in the next section. But much debate has arisen from the use of submarkets in the analysis of unilateral competitive effects of mergers. This topic will be addressed below in Part III.

II. PRICE DISCRIMINATION

The term price discrimination market is applied when a hypothetical monopolist of a group of products and location would raise price profitably to a class of targeted buyers, notwithstanding the incentive of buyers

[16] *Accord* HOVENKAMP, *supra* note 15, § 3.2c ("the existence of a relatively large relevant market does not preclude the existence of smaller markets within it.").

[17] 1992 Merger Guidelines, *supra* note 2, § 1.1.

[18] *E.g.*, Olin Corp. v. FTC, 986 F.2d 1295, 1301 (9th Cir. 1993) (existence of a narrow relevant product market does not preclude a finding of violation in a broader market that encompasses the narrow market).

to substitute to other products and more distant sellers or to attempt to purchase the product in resale from more favored buyers.[19] Commentators and courts have recognized that at least some of the *Brown Shoe* factors—particularly distinct customers—can be used to identify this situation.[20]

Ansell Inc. v. Schmid Laboratories, Inc.[21] provides a representative example.[22] Ansell, the plaintiff, proposed to define a market consisting of the sale of latex condoms through retail outlets in the United States. Defendant Schmid sought to broaden the market to encompass all wholesale condom sales in the United States. The broader product market would include condom sales to the U. S. Agency for International Development (USAID) through a substantial annual bulk procurement auction.[23] Condoms were typically sold to USAID for only one-quarter of the price the manufacturers received from retail distributors. USAID distributed the condoms it purchased free of charge in third-world countries; there was apparently little possibility that these low-cost condoms would be resold to domestic retailers.

On these facts, market definition would be straightforward under the approach of the Merger Guidelines. A hypothetical condom monopolist would likely be able to charge a high price to retailers even if it charged

[19] 1992 Merger Guidelines, *supra* note 2, § 1.12 (product market definition in the presence of price discrimination), § 1.22 (geographic market definition in the presence of price discrimination).

[20] The commentary includes, e.g., 2A AREEDA ET AL., *supra* note 13, § 533d ("A common situation inviting submarket talk is price discrimination."); ABA ANTITRUST SECTION MONOGRAPH, *supra* note 13, at 130; Keyte, *supra* note 13, at 739–45; *cf.* Maisel, *supra* note 11, at 55, 63, 66 (recognizing that "distinct customers" may help define price discrimination markets while encouraging courts to resist the temptation to label those markets submarkets).

[21] 757 F. Supp. 467 (D. N.J.) (rejecting antitrust challenge to an acquisition by the target for failure to show antitrust injury), *aff'd*, 941 F.2d 1200 (3d Cir. 1991).

[22] For other examples, see, e.g., Grumman Corp. v. LTV Corp., 527 F. Supp. 86, 90 (E.D.N.Y.) (defining, based on *Brown Shoe* factors, a submarket of carrier-based aircraft sold to the U.S. Navy), *aff'd*, 665 F.2d 10 (2d Cir. 1981); Harnischfeger Corp. v. Paccar, Inc., 474 F. Supp. 1151 (E.D. Wis.) (large mining excavator loader submarket defined, distinct from hydraulic mining excavators, in part because the former have distinct customers in surface miners and very heavy earth-moving contractors), *aff'd*, 624 F.2d 1103 (7th Cir. 1979); Avnet, Inc. v. FTC, 511 F.2d 70, 78–79 (7th Cir. 1975) (upholding submarket defined as sale of new components for automotive electrical units to production-line rebuilders, excluding sales to repair shops based on functional differences between the customer classes); FTC v. Cardinal Health, Inc., 12 F. Supp. 2d 34, 46–49 (D.D.C. 1998) (drug distribution through wholesalers submarket defined within a broader product market encompassing the delivery of prescription drugs by all forms of distribution, where certain customer classes (hospitals, independent pharmacies, and non-warehousing retail drug chains) lack good distribution alternatives).

[23] The procurement auction was conducted by the General Services Administration for USAID; for simplicity, USAID is termed the buyer.

a low price to USAID.[24] If retailers (or their customers) were targeted buyers against whom a hypothetical condom monopolist would discriminate in price, condoms sold at retail would properly constitute an antitrust product market.

The court relied upon the *Brown Shoe* factors to reach a similar conclusion, finding that the narrow market proposed by Ansell constituted a submarket within the broader market alleged by Schmid. For example, the court found that condoms sold at retail were recognized by the industry as a separate economic entity, and that retail distributors are a customer group distinct from USAID.[25] Moreover, condoms were sold to the two groups at distinct prices, and the price of latex condoms sold to USAID was not sensitive to changes in the price of condoms sold to the retail trade.

III. PRODUCT DIFFERENTIATION

Many of the most controversial uses of the submarket concept involve its application to analyze mergers or acquisitions in industries in which products are differentiated. Product differentiation is pervasive in the economy. Goods or services may differ along a wide range of physical and non-physical characteristics, such as features, colors, and style, geographic location, point-of-sale or post-sale services (for example, demonstrations or warranties), seller reputations for quality, delivery time, defect rate, and non-physical attributes of brands (for example, related to lifestyle). Examples of product differentiation might include branded consumer product industries, such as soft drinks and breakfast cereals; markets in which buyers see important differences in the nature or quality of services offered by potential suppliers, such as automotive steel or auditing services provided by accounting firms; or industries, such as supermarkets or hospitals, where differences in seller locations are important to buyers.

A merger among sellers in differentiated product industries may harm competition if it results in the loss of "localized" competition among products sold by the parties.[26] Put differently, the transaction may be

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[24] If USAID is more price sensitive than retail condom buyers, a condom monopolist would likely find it profitable to price discriminate in this way.

[25] 757 F. Supp. at 472–73.

[26] Competition may be localized if sellers have different geographic locations, and buyers find it costly to shift from nearby to more distant sellers. Such buyers will typically choose among nearby sellers, and not patronize distant sellers unless the latter undercut the price of nearby sellers by more than the transportation costs of making transactions at a distance. Competition is also termed localized if sellers have different locations in a metaphorical "product space," and buyers have preferences among seller or product characteristics. Such buyers will typically choose among sellers with similar product offerings, and not

harmful if it removes an important source of competitive discipline for any or all of the two firms' products.[27] Although this theory of harmful competitive effects of mergers may not have been well understood in 1962,[28] the extent of localized competition among the merger partners depends on the same economic force long recognized to be at issue in market definition: buyer substitution. Accordingly, it is possible, in principle, to use the tool of market definition—and the *Brown Shoe* practical indicia, to the extent they are proxies for buyer substitution—to identify mergers that would lead to higher prices through the loss of localized competition.

The decision in *Federal Trade Commission v. Staples, Inc.*[29] provides a recent example of a district court that appears to have found its way to prohibiting a merger that would lead to the loss of significant localized competition by following the analytic route of defining a narrow market based on applying the *Brown Shoe* practical indica of submarkets.[30] This

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substitute sellers offering products with very different characteristics unless the latter offer their products at a substantial discount. In both situations, neighboring sellers (in geographic or product space) more closely compete with each other than with more distant sellers.

[27] If a firm selling product *A* acquires product *B* from a rival, the merged firm's unilateral post-merger incentive to raise the price of product *A* will be greater the larger the number of buyers of product *A* who would react to a price increase by shifting to product *B*. *See generally* 1992 Merger Guidelines, *supra* note 2, at § 2.21; Jonathan B. Baker, *Product Differentiation Through Space and Time: Some Antitrust Policy Issues*, 42 ANTITRUST BULL. 177 (1997); Jonathan B. Baker, *Unilateral Competitive Effects Theories in Merger Analysis*, ANTITRUST, Spring 1997, at 21; Carl Shapiro, *Mergers with Differentiated Products*, ANTITRUST, Spring 1996, at 23.

[28] This theory did not become important in antitrust practice until after economists developed ways to quantify the magnitude of the anticompetitive effects; the use of econometric techniques to do so began with my work with Timothy Bresnahan on the use of residual demand estimation in merger analysis. Jonathan B. Baker & Timothy F. Bresnahan, *The Gains from Merger or Collusion in Product-Differentiated Industries*, 33 J. INDUS. ECON. 427 (1985). The theory did not appear in the Merger Guidelines until 1992 (where it is termed the lessening of competition through unilateral competitive effects among firms distinguished primarily by differentiated products).

[29] 970 F. Supp. 1066 (D.D.C. 1997).

[30] It is not always clear whether judges who define a narrow submarket within a broader market do so in order to recognize localized competition among sellers of differentiated products, for two reasons: courts that rely on a strong presumption of harm to competition from mergers leading to high and increasing concentration do not need to explain their theory of how the transaction will harm competition; and identifying localized competition is closely related to market definition. Still, there are a number of plausible candidates aside from *Staples*. *See, e.g.*, U.S. Anchor Mfg., Inc. v. Rule Indus., Inc., 7 F.3d 986 (11th Cir. 1993) (excluding Danforth brand anchors from a lightweight generic and economy fluke anchors product market, notwithstanding functional interchangeability, based on *Brown Shoe* practical indicia); Olin Corp. v. FTC, 986 F.2d 1295 (9th Cir. 1993) (employing the *Brown Shoe* factors to define a product market of dry sanitizer swimming pool chemicals within a broader "all pool sanitizers" market that also included liquid bleach); Bon-Ton Stores, Inc., v. May Dept. Stores Co., 881 F. Supp. 860 (W.D.N.Y. 1994) (department stores

example illustrates the advantages and drawbacks of this controversial use of the submarket concept.

The *Staples* case arose out of an FTC challenge to Staples' proposed acquisition of Office Depot. Both of these firms sell office supplies in a superstore format. At the time of the transaction, they each operated over 500 stores covering much of the country, as did a third superstore chain, OfficeMax. Office supplies also were sold by a variety of other types of retailers, including independent retail office supply stores, mass merchandisers like Wal-Mart and Kmart, wholseale clubs like B.J.'s and Price Costco, computer or electronic stores like Best Buy and CompUSA, mail order firms like Quill and Viking, and contract stationers.

Product market definition was perhaps the most hotly contested issue in the case; indeed, the trial judge observed that the outcome "hinges" on the proper market definition.[31] The court began its analysis of this question by defining a broad market encompassing the sale of consumable office supplies by all sellers, recognizing "that those sellers must, at some level, compete with one another."[32] But the court went on to define a submarket consisting of the sale of consumable office supplies by office superstores, relying on an application of the *Brown Shoe* practical indica as legal authority for doing so.

The trial judge recognized that his market definition had to "overcome" a "first blush" or "initial gut reaction" that the product market must include all retailers of office supplies.[33] After all, "[t]he products . . . are undeniably the same no matter who sells them, and no one denies that many different types of retailers sell those products."[34] The judge also noted two other reasons for questioning his decision to limit the market to the sale of office supplies by superstores: the fact that "Staples and Office Depot do not ignore [non-superstore] sellers such as warehouse clubs, Best Buy, or Wal-Mart,"[35] and skepticism by some

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product submarket); Remington Prods., Inc. v. North American Philips Corp., 717 F. Supp. 36 (D. Conn. 1989) (electric shaver submarket); Tasty Baking Co., Inc. v. Ralston Purina, Inc., 653 F. Supp. 1250 (E.D. Pa. 1987) (defining a snack cakes and pies submarket, though not recognizing a market for premium snack cakes and pies); Weeks Dredging & Contracting, Inc. v. American Dredging Co., 451 F. Supp. 468 (E.D. Pa. 1978) (bucket dredging submarket within all dredging market); United States v. Mrs. Smith's Pie Co., 440 F. Supp. 220 (E.D. Pa. 1976) (frozen dessert pies market); United States v. Black and Decker Mfg. Co., 430 F. Supp. 729 (D. Md. 1976) (product submarket of lightweight, inexpensive gasoline powered saws sold to occasional users).

[31] *Staples*, 970 F. Supp. at 1073.

[32] *Id.* at 1075.

[33] *Id.*

[34] *Id.*

[35] *Id.* at 1079.

other courts about the existence of "submarkets similar to the one found . . . in this case."[36] Moreover, the court's factual conclusion that "office superstores are . . . very different in apperance, physical size, format, the number and variety of SKU's offered, and the type of customers targeted and served than other sellers of office supplies" appears to be based more on a qualitative judgment than hard evidence.[37]

What initially appeared to be a difficult market definition problem was made easy for the trial court by the "compelling" pricing evidence,[38] which the court found to correspond with *Brown Shoe*'s "sensitivity to price changes" factor.[39] That evidence showed that Staples charged significantly higher prices—at least 5 percent and as much as 13 percent higher—in geographic markets where it had no office superstore competition than in markets where it competed with the two other superstore chains,[40] notwithstanding the presence of a wide range of non-superstore retailers of office supplies in the single superstore markets.[41] The pricing evidence was reinforced by the "abundant" evidence on another *Brown Shoe* factor, industry recognition of the submarket as a separate economic entity; in internal documents of the merging firms, the parties "refer to, discuss, and make business decisions based upon the assumption that 'competition' refers to other office superstores only."[42] Of these two factors, the pricing evidence was the more important. The court noted that the proof offered by the FTC focused "primarily" on it,[43]

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[36] *Id.* at 1081. The judge saw the prior decisions as mixed, and observed that he was not the first to find a narrower submarket within a larger market. *Id.* at 1080.

[37] *Id.* at 1078. The court observed that "[i]t is difficult to fully articulate and explain all of the ways in which superstores are unique."*Id.* at 1079. When defending this conclusion in quantitative terms, the trial judge employed highly qualified sentences, such as: "While the Court accepts that some small businesses with fewer than 20 employees as well as home office customers do choose other sellers of office supplies, the superstores' customers are different from those of *many of* the purported competitors." *Id.* at 1078 (emphasis added). In contrast, after visiting the various stores in person, the judge felt confident making the qualitative judgment: "You certainly know an office superstore when you see one." *Id.* at 1079.

[38] *Id.* at 1076.

[39] *Id.* at 1075.

[40] *Id.* at 1076. The court relied both on evidence of pricing differentials across markets (finding that Staples charged higher prices in cities where Staples did not face superstore markets) and evidence of pricing differentials across time that varied with the extent of superstore competition (finding that Staples changed price zones to lower prices when faced with entry of another superstore, but not for other retailers). *Id.* at 1077–78. Similarly, the FTC's econometric evidence, also based on both cross-section and time series analyses, showed that the merger would likely lead to an 8% increase in Staples' prices. Jonathan B. Baker, *Econometric Analysis in* FTC v. Staples, 18 J. PUB. POL'Y & MKTG. 11 (1999).

[41] *Staples*, 970 F. Supp. at 1077.

[42] *Id.* at 1079.

[43] *Id.* at 1075.

while also observing that the documentary evidence on the other factor, industry recognition, did not point exclusively in one direction.[44]

Within the product submarket of consumable office supplies sold through superstores, the proposed merger was a merger to monopoly in many geographic markets (metropolitan areas), and it increased concentration substantially in many other markets where OfficeMax would remain as a superstore competitor.[45] This was not the only indication that a merger between Staples and Office Depot would lessen competition. The court explained that the evidence on pricing, which it discussed with respect to defining the relevant product market, also indicated that the transaction would harm competition—because "an office superstore chain facing no competition from other superstores has the ability to profitably raise prices for consumable office supplies above competitive levels."[46]

When the court discussed the likely competitive effects of the merger, it explained that the transaction would lead to higher prices through the loss of localized competition among the merging superstore chains:

> [D]irect evidence shows that by eliminating Staples' most significant, and in many markets only, rival, this merger would allow Staples to increase prices or otherwise maintain prices at an anticompetitive level. The merger would eliminate significant head-to-head competition between the two lowest cost and lowest priced firms in the superstore market.[47]

This passage articulates a competitive effects theory consistent with the unilateral effects theory for mergers among differentiated products set forth in the Merger Guidelines, though the court, having defined a narrow market, did not frame its theory that way. The court's theory does not rely upon coordination among firms beyond the merger partners. Had the court instead defined only a broader market, it should still have found harm to competition from the loss of "head-to-head competition" between a firm and a "significant" rival among sellers of differentiated products, that would demonstrably (with "direct evidence") allow the firm to "increase prices." Neither the scope of the relevant product market nor market shares (which provide indirect evi-

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[44] *Id.* at 1079 (finding that "Staples and Office Depot do not ignore [non-superstore] sellers such as warehouse clubs, Best Buy, or Wal-Mart").

[45] *Id.* at 1081. In addition, the court noted that allowing the defendants to merge would eliminate future competition in cities where the two firms, which were expanding rapidly, would likely have entered in competition with each other. *Id.* at 1082.

[46] *Id.* at 1082.

[47] *Id.* at 1083 (footnote omitted).

dence about a matter on which powerful direct evidence was available) should alter this reasoning.

The *Staples* case highlights the benefit of defining *Brown Shoe* submarkets for addressing the loss of localized competition resulting from mergers among sellers of differentiated products. Had the court not defined a submarket of office supply sales through superstores, but instead analyzed the transaction exclusively in a broader market of all retail sales of consumable office supplies, the merger would have led to a tiny increase in market concentration; the court observes that the combined firm would have only a 5.5 percent share of that overall market.[48] Under such circumstances, the direct evidence that the merger would lead to higher prices by reducing localized competition would have appeared in conflict with indirect evidence, derived from market concentration, suggesting that the transaction was unlikely to harm competition. The direct evidence that the merger would harm competition would have been just as powerful, and the indirect evidence that it would not harm competition would have been weak, given that market shares are poor predictors of the extent of localized competition among sellers of differentiated products,[49] but the court nevertheless would have been required to make the case for preferring the direct pricing evidence in the face of very low market shares. In contrast, after defining the submarket, market concentration evidence and direct evidence pointed to the same conclusion; the court had no need to explain away low market shares.

Staples also suggests the problems with relying on *Brown Shoe* submarkets to address the loss of localized competition from merger. Most important, market definition becomes an expositional tool rather than an analytic tool when, as in *Staples*, it is "reverse engineered." The *Staples* court first credited the evidence that direct competition between Staples and Office Depot lowers price where the two were head-to-head (particularly in the absence of OfficeMax), then used that pricing evidence as the main basis for defining a superstore market. Leading with the pricing evidence was a good litigation strategy on the part of the FTC trial team and a useful rhetorical device for the judge to explain his decision, because it permitted both the Commission staff and the court to sidestep a seeming disjunction between direct evidence of likely anticompetitive effects from defendants' pricing and indirect evidence derived from market concentration. But when this approach is employed, market definition is not being used as intended, namely to help the court determine whether the transaction will likely harm competition.

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[48] *Id.* at 1075.

[49] *E.g.*, Baker, *Product Differentiation*, *supra* note 27, at 183.

In other words, if the answer to the ultimate question (whether price will rise) is the basis for market definition, market definition and market concentration are conclusory, not an autonomous method of analysis.

In other cases, moreover, the submarket reflective of localized competition may not be as simple to describe or as easy to identify as the superstore submarket in *Staples*. Had a court been asked to analyze a hypothetical merger between Anheuser-Busch (Budweiser) and Pabst during the late 1970s, for example, it might have been faced with direct evidence (as from econometric analyses[50]) that the transaction would have led to an increase in the price of Budweiser.[51] To recognize that localized competition through submarket analysis, a court might have needed to define a product submarket limited to Budweiser and Pabst; otherwise the market would surely include Miller, and concentration might not have risen sufficiently to suggest a competitive problem.[52] But it might not have been possible to reach a Budweiser-Pabst product market in the hypothetical example through the standards of the Merger Guidelines for two reasons. First, if the Budweiser price increase would not quite reach the "small but significant" price increase benchmark in the Guidelines (often 5 percent), the market would need to be broadened.[53] Second, if, in the event of a Budweiser price increase, more Budweiser drinkers switch to Miller than to Pabst, the market definition exercise beginning with Budweiser would add Miller before it added Pabst—notwithstanding the presence of significant localized competition between Budweiser and Pabst.[54] Even absent these problems, moreover, a court would be wary of defining a product market limited to Budweiser and Pabst. A decision to exclude Miller could readily appear to

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[50] With econometric methods, it may be possible to make fine distinctions about the competitive role played by individual products in branded consumer products industries. Econometric methods employed in antitrust are surveyed in Jonathan B. Baker & Daniel L. Rubinfeld, *Empirical Methods in Antitrust Litigation: Review and Critique*, 1 AM. L. & ECON. REV. 386 (1999). *See also* Daniel L. Rubinfeld, *Market Definition with Differentiated Products: The Post-Nabisco Cereal Merger*, 68 ANTITRUST L.J. 163 (2000); Jonathan B. Baker & Timothy F. Bresnahan, *Empirical Methods of Identifying and Measuring Market Power*, 61 ANTITRUST L.J. 3 (1992).

[51] *See* Baker & Bresnahan, *supra* note 28.

[52] In the actual brewing industry of the late 1970s, the market shares of Budweiser and Pabst would probably have been high enough to keep the merger out of the Guidelines' safe harbors in many plausible geographic markets. But localized competition between Pabst and Budweiser could have been just as important in other plausible geographic markets where the firms were much smaller.

[53] The smaller price rise would remain anticompetitive; the 5% test is simply a methodologcial tool, not a tolerance level for a price increase. 1992 Merger Guidelines, *supra* note 2, § 1.0.

[54] *See id.* § 1.11 (requiring addition of "next-best substitute" when expanding provisional market).

reflect result-oriented gerrymandering by the judge rather than careful analysis.[55] This risk is particularly strong in differentiated-product industries characterized by a proliferation of products differing in small ways across multiple dimensions.[56]

Furthermore, a Budweiser-Pabst submarket is probably not the same product market the court would define were it interested in assessing the likelihood that the merger would increase the probability or effectiveness of industry coordination.[57] While coordination between these two firms could have led to a small anticompetitive price increase, coordination among all brewers would plausibly result in a much larger price rise for these and many other brands.[58] A market definition suitable for analyzing the loss of localized competition may well be unduly narrow for analyzing the likelihood of post-merger coordination, even though the same economic force, buyer substitution, is at stake in each. There is no theoretical bar to using the market definition machinery—and the *Brown Shoe* practical indicia—to identify submarkets in which localized competition is important, even if a broader market is also defined for analyzing the likelihood of coordinated competitive effects.[59] But in an era in which every contested market delineation favoring plaintiffs risks criticism as result-driven gerrymandering—when the music of market definition is captured by the slogan "there are no submarkets, only markets"—reliance upon market definition as the methodology for isolat-

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[55] The *Staples* court was protected against this charge by the presence of evidence consistent with another *Brown Shoe* factor, industry recognition of the submarket. But this factor will not be present in every case where competition is localized.

[56] *Cf.* James A. Keyte, *Premium Fountain Pens and Gift Boxed Chocolates: Market Definition and Differentiated Products*, ANTITRUST, Fall 1993, at 19, 22 ("the more choices available to consumers in industries with differentiated products, the more likely the market will be defined broadly or anticompetitive effects will not be found").

[57] To reach the broader market under the Merger Guidelines, the court might choose to apply a "small but significant" price increase benchmark greater than 5% when analyzing the prospects for coordination, even if it used a 5% or lower price increase benchmark for analyzing the potential loss of localized competition. *See* 1992 Merger Guidelines, *supra* note 2, § 1.11 (although a 5% figure will be employed "in most contexts," the appropriate benchmark "will depend on the nature of the industry" and the agency may "at times" use a higher or lower figure); *cf.* Steven C. Salop, *The First Principles Approach to Antitrust,* Kodak, *and Antitrust at the Millennium,* 68 ANTITRUST L.J. 187 (2000) ("Market power and market definition . . . should not be analyzed in a vacuum . . . divorced from the conduct and allegations about its effects.").

[58] Even if Pabst had a small share in a broad market, its acquisition could facilitate coordination, for example, if it were a "maverick" whose presence made it difficult for the two major firms, Anheuser-Busch and Miller, to reach or enforce a tacit cartel arrangement with other brewers that would allow the industry participants to capture much of the monopoly profits potentially available in the beer market. *See* 1992 Merger Guidelines, *supra* note 2, § 2.11 (potential harm from the acquisition of a maverick firm that limits coordination among its rivals).

[59] *See supra* notes 16–18 and accompanying text.

ing localized competition risks jeopardizing the role of market definition in the coordination inquiry, where market definition and market shares are generally more useful to the analysis. In short, the submarket strategy for identifying the loss of localized competition has strong potential for confusion with the traditional strategy for identifying mergers that are likely to make coordination more likely or more effective.

At their root, these problems with the strategy of identifying unilateral competitive effects of mergers in differentiated products industries through narrow market definitions arise because market definition is generally not very helpful as a first step in assessing the potential loss of localized competition.[60] Market shares—the immediate implications of market definition—often reveal little about the competitive role played by individual firms in differentiated product industries or the nature of localized competition among market participants.[61] Accordingly, when the goal is to identify the loss of localized competition, market definition can be expected to have a conclusory aspect to it: It would not be employed as a method analyzing anticompetitive possibilities but instead used as a way to articulate a competitive effect identified through other means, as through the pricing evidence proffered in *Staples.*[62]

IV. CONCLUSION

Submarkets identified through the *Brown Shoe* practical indicia have been employed by courts to address buyer substitution, seller substitution,

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[60] *Cf.* James F. Rill, *Practicing What They Preach: One Lawyer's View of Econometric Models in Differentiated Products Mergers*, 5 GEO. MASON L. REV. 393, 401 (1997) (enforcement agency economists "appear to be employing an approach which undertakes to identify effects first," before defining a relevant market, when assessing the possible loss of localized competition among sellers of differentiated products). In contrast, when the goal is to identify mergers that make coordination more likely or more effective, it is generally useful, as well as traditional, to commence the analysis by identifying a set of products and locations that would constitute a valuable monopoly (market definition) and determining the identity of the firms participating in that market and their market shares. The likelihood that those firms would successfully reduce output and raise price collectively after the market's structure has changed through acquisition can then be assessed by examining market shares, in conjunction with other information.

[61] *See* Baker, *Product Differentiation, supra* note 27, at 183. The competitive role played by an individual firm in a differentiated product industry can be complex. Any individual product or location will typically have both closer and more distant substitutes from the perspective of buyers, and substitution patterns need not be symmetric. Jonathan B. Baker, *Contemporary Empirical Merger Analysis*, 5 GEO. MASON L. REV. 347, 357 & n.39 (1997).

[62] If the likely harm to competition from a merger can be demonstrated directly, there must exist a market where harm will occur, but there is little need for a court to specify the market's precise boundaries. *See* Baker, *Product Differentiation, supra* note 27, at 185–87 (proposing "res ipsa loquitur" market definition). Market definition would still be required if safe harbors based on concentration are to be applied, however.

price discrimination markets, and localized competition at risk of loss from merger. Market definition is well suited for recognizing buyer substitution, and is used that way in the modern Merger Guidelines. But, as the Guidelines also recognize, seller substitution is best handled through other analyses—assigning market shares to entrants capable of providing new competition quickly and with little sunk expenditures, and analyzing whether other entry would be timely, likely, and sufficient. Price discrimination markets can also be identified using some *Brown Shoe* factors; the Merger Guidelines clarify how and why.

Much of the controversy involving submarket definition arises from its use to define narrow markets to capture localized competiton in differentiated-product industries. Because the identification of localized competition turns on the same economic force at issue in market definition, i.e., buyer substitution, courts have been drawn to the well-established doctrines of market and submarket definition for doing so. This is a healthy development as a doctrinal way station toward incorporating unilateral competitive effects doctrine directly into the case law, as exemplified in the *Staples* case. But it is ultimately not the best way to approach unilateral competitive effects because market definition is generally not very helpful as a first step in assessing the potential loss of localized competition. I have argued elsewhere that antitrust doctrine can be expected to adapt to this situation by giving a greater role to direct evidence of harm to competition in evaluating mergers among sellers of differentiated products, and a lesser role to market definition and market shares in such settings.[63] To the extent this occurs, the controversy over *Brown Shoe* submarkets likely will abate.

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[63] *See* Baker, *Product Differentiation, supra* note 27, at 185–87; Baker, *Contemporary Empirical Merger Analysis, supra* note 61, at 351.