Picture this: After months of fierce negotiation and loads of due diligence, your client signed a definitive agreement that will be its make-or-break transaction. While you've been checking off items on the closing checklist, things have gone downhill at the target company. In this hypothetical case, Congress has drastically reduced the reimbursement rates applicable to the target’s healthcare business. When your client calls to ask whether or not the deal is terminable, you flip through the definitive agreement and realize that all conditions to closing have been satisfied other than those relating to material adverse changes.

Will the regulatory change excuse your client from the planned transaction? What if a target company were to announce, after execution of the deal, accounting fraud, new litigation that could carry enormous liability, a recall of its primary product, failure to meet projected earnings, mass tort liability, patent infringement, diminished sales, or just major financial difficulties as a result of tough economic times? Would these facts excuse your client from closing the transaction because they would constitute material adverse changes?

In this article, we examine what to say to our clients when faced with situations like those described above. We also review and analyze the techniques for drafting a “material adverse change” or “MAC” clause to create an agreement that best reflects the allocation of risks regarding known events as well as unknown events, and one that will survive judicial scrutiny if challenged with the benefit of hindsight. (While the agreements we cite each refer to “material adverse effect” or “MAE” clauses, we use MAC for simplicity throughout, and the terms are practically synonymous.) Without a crystal ball, transactional lawyers must attempt to draft provisions to allow for new facts that, had they been present prior to execution of a definitive agreement, might have resulted in the buyer’s never having done the deal in the first place, while giving due regard to the target’s desire for certainty that the transaction will close.

As discussed below, Delaware courts have set a very difficult standard for when they will find that a MAC exists. Consequently, it is, in fact, important to let the buyer beware of a likely inability to walk away from a deal because of a MAC.

What Is a MAC?
Typically, MACs are referenced in various places in transaction documents, most prominently in the following:

(1) Conditions Precedent—MAC clauses that are conditions precedent present scenarios in which a party may refuse to close the transaction without being in breach. E.g., a buyer’s obligation to close may be conditioned upon the absence of a MAC.

(2) Representations and Warranties—MAC clauses that qualify representations and warranties establish a materiality standard that typically increases the difficulty for finding a breach above the mere use of the word “material” as a qualifier. E.g., a target may qualify its representation as follows: “Each of Target and its subsidiaries is . . . except where the failure . . . would not result in a MAC.” Because the representations and warranties are generally “brought down” at closing, this usage of the MAC also affects closing conditions.

(3) Obligations—MACs may give rise to obligations of the parties. E.g., a target may be required to give notice to the buyer in the event of (or within a stated period of time after the occurrence of) a MAC.

Elements of a MAC
Below, we present and examine MAC clauses in three recent healthcare industry transactions, chosen to highlight differences (or lack thereof) over time (2007, 2008, and 2009), industry (healthcare providers or pharmaceutical manufacture/distribution), structure (whole company merger and single facility asset purchase), size (multi-billion or multi-million), and context (healthy target or distressed target).
<table>
<thead>
<tr>
<th>Agreement and Plan of Merger among Pfizer, Inc., Wagner Acquisition Corp., and Wyeth, dated as of January 25, 2009 (referred to herein as “Wyeth”)</th>
<th>Agreement and Plan of Merger by and among Triad Hospitals, Inc., Community Health Systems, Inc., and FWCT-1 Acquisition Corporation, dated March 19, 2007 (referred to herein as “Triad”)</th>
<th>Asset Purchase Agreement, dated as of Dec. 28, 2007, by and among Sun Coast Hospital, Inc., Sun Coast Imaging Center, LLC, and Largo Medical Center, Inc. (referred to herein as “Sun Coast”)</th>
</tr>
</thead>
</table>
| “Company Material Adverse Effect” means an effect, event, development, change, state of facts, condition, circumstance or occurrence that is or would be reasonably expected to be materially adverse to the financial condition, assets, liabilities, business or results of operations of the Company and its Subsidiaries, taken as a whole; provided, however, that a Company Material Adverse Effect shall not be deemed to include effects, events, developments, changes, states of facts, conditions, circumstances or occurrences arising out of, relating to or resulting from: (A) changes generally affecting the economy, financial or securities markets or political or regulatory conditions, to the extent such changes do not adversely affect the Company and its Subsidiaries in a disproportionate manner relative to other participants in the pharmaceutical or biotechnology industry; (B) changes in the pharmaceutical or biotechnology industry, to the extent such changes do not adversely affect the Company and its Subsidiaries in a disproportionate manner relative to other participants in such industry; (C) any change in Law or the interpretation thereof or GAAP or the interpretation thereof, to the extent such changes do not adversely affect the Company and its Subsidiaries in a disproportionate manner relative to other participants in such industry; (D) any change in the interpretation of applicable Law across such industries, (E) the announcement of this Agreement or the pendency of the transactions contemplated hereby, including disputes or any fees or expenses incurred in connection therewith or any labor union activities or disputes, (F) the identity of Parent or any of its Affiliates as the acquiror of the Company, (G) compliance with the terms of, or the taking of any action required by, this Agreement or consented to by Parent, (H) any acts of terrorism or war or any natural disaster or weather-related event (other than any of the foregoing that causes any damage or destruction to or by the ability of Seller to consummate the transactions contemplated by this Agreement or to perform its obligations under this Agreement. Without limiting the foregoing, and solely for purposes of determining whether or not a Material Adverse Effect has occurred with respect to results of operations or financial prospects of the Hospital, the following unfavorable changes shall not be considered a Material Adverse Effect: (A) EBITDA (excluding legal fees in connection with the transactions contemplated by this Agreement, amounts payable as professional fees to third parties in connection with the administration of the Bankruptcy Cases, and court costs in connection with the Bankruptcy Cases) on a two-month trailing average basis reflects | “Material Adverse Effect on the Company” means any event, state of facts, circumstance, development, change, effect or occurrence that is materially adverse to (x) the ability of the Company to timely perform its obligations under this Agreement, or (y) the business, financial condition or results of operations of the Company and its Subsidiaries, taken as a whole, other than any event, state of facts, circumstance, development, change, effect or occurrence resulting from (A) changes in general economic or political conditions or the securities, credit or financial markets in general, (B) general changes or developments in the industries in which the Company and its Subsidiaries operate, including general changes in applicable Law across such industries, (C) the announcement of this Agreement or the pendency of the transactions contemplated hereby, including disputes or any fees or expenses incurred in connection therewith or any labor union activities or disputes, (D) the identity of Parent or any of its Affiliates as the acquiror of the Company, (E) compliance with the terms of, or the taking of any action required by, this Agreement or consented to by Parent, (F) any acts of terrorism or war or any natural disaster or weather-related event (other than any of the foregoing that causes any damage or destruction to or by the ability of Seller to consummate the transactions contemplated by this Agreement or to perform its obligations under this Agreement. Without limiting the foregoing, and solely for purposes of determining whether or not a Material Adverse Effect has occurred with respect to results of operations or financial prospects of the Hospital, the following unfavorable changes shall not be considered a Material Adverse Effect: (A) EBITDA (excluding legal fees in connection with the transactions contemplated by this Agreement, amounts payable as professional fees to third parties in connection with the administration of the Bankruptcy Cases, and court costs in connection with the Bankruptcy Cases) on a two-month trailing average basis reflects | “Material Adverse Effect” means any event, occurrence, fact, condition, change or effect that is, or is reasonably likely in the future to be, individually or in the aggregate, materially adverse to the business, operations, prospects, results of operations, condition (financial or otherwise), properties (including intangible properties), rights, obligations or Assets of Seller or the Hospital or (ii) materially impairs or delays, or is reasonably likely to materially impair or delay, the ability of Seller to consummate the transactions contemplated by this Agreement or to perform its obligations under this Agreement. 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adversely affect the Company and its Subsidiaries in a disproportionate manner relative to other participants in such industry; (D) acts of war, armed hostility or terrorism to the extent such changes do not adversely affect the Company and its Subsidiaries in a disproportionate manner relative to other participants in the pharmaceuticals or biotechnology industry; (E) any change attributable to the negotiation, execution or announcement of the Merger, including any litigation resulting therefrom, and any adverse change in customer, distributor, employee, supplier, financing source, licensor, licensee, sub-licensee, stockholder, co-promotion or joint venture partner or similar relationships, including as a result of the identity of Parent; (F) any failure by the Company to meet any internal or published industry analyst projections or forecasts of revenues or earnings for any period (it being understood and agreed that the facts and circumstances giving rise to such failure that are not otherwise excluded from the definition of a Company Material Adverse Effect may be taken into account in determining whether there has been a Company Material Adverse Effect); (G) changes in generally accepted accounting principles or the interpretation thereof, (H) changes in the price or trading volume of the Common Stock (provided that the underlying causes of such price or volume changes nonetheless shall be considered in determining whether there is a Material Adverse Effect on the Company), (I) any legal proceedings made or brought by any of the current or former stockholders of the Company (on their own behalf or on behalf of the Company) arising out of or related to this Agreement or the Merger, or (J) any failure to meet internal or published projections, forecasts or revenue or earning predictions for any period (provided that the underlying causes of such failure nonetheless shall be considered in determining whether there is a Material Adverse Effect on the Company except as otherwise excluded from the definition of Material Adverse Effect on the Company pursuant to this Agreement), except, in the case of the foregoing clauses (A) and (B), to the extent such changes or developments referred to therein would reasonably be expected to have a materially disproportionate impact on the Company and its Subsidiaries, taken as a whole, relative to other for profit participants in the industries and in the geographic markets in which the Company conducts its businesses after taking into account the size of the Company relative to such other for profit participants.

renders unusable any material Facility of the Company or any of its Subsidiaries), (G) changes in generally accepted accounting principles or the interpretation thereof, (H) changes in the price or trading volume of the Common Stock (provided that the underlying causes of such price or volume changes nonetheless shall be considered in determining whether there is a Material Adverse Effect on the Company), (I) any legal proceedings made or brought by any of the current or former stockholders of the Company (on their own behalf or on behalf of the Company) arising out of or related to this Agreement or the Merger, or (J) any failure to meet internal or published projections, forecasts or revenue or earning predictions for any period (provided that the underlying causes of such failure nonetheless shall be considered in determining whether there is a Material Adverse Effect on the Company except as otherwise excluded from the definition of Material Adverse Effect on the Company pursuant to this Agreement), except, in the case of the foregoing clauses (A) and (B), to the extent such changes or developments referred to therein would reasonably be expected to have a materially disproportionate impact on the Company and its Subsidiaries, taken as a whole, relative to other for profit participants in the industries and in the geographic markets in which the Company conducts its businesses after taking into account the size of the Company relative to such other for profit participants.

a loss of $525,000 or less; or (B) a decrease in admissions of 30% or less as compared to the prior month.
(1) **Changes**—The most fundamental issue relating to a MAC clause is establishing the universe of changes that are candidates for attaining MAC status. Related issues include:

(a) Will evaluation of the changes consider not only current operations of the relevant business, but also that business’ prospects (perhaps making a MAC more easily found)?

(b) Will the changes include not only those that have occurred but also those “reasonably likely to occur”? (c) Will a quantitative threshold be established for the size changes must be in order to constitute MACs? (In that regard, we note that utilization of a quantitative threshold has the benefit of certainty of an objective test (e.g., in a healthcare facility transaction, MACs may include a decrease in admissions of X%), but may create a strange result, such as having a change of $1 determinative of existence of a MAC.)

Each of these matters requires analysis of the facts of each situation, and there is no determinative rule that can be applied generally.

As the boldfaced language in the examples above demonstrates, we find a range of definitions of “change.” Triad has no forward-looking element, although Delaware courts may apply this concept in any event, as discussed below. Wyeth incorporates a form of the “reasonably likely to occur” modifier. Sun Coast refers both to “prospects” and those changes that are “reasonably likely to occur.” Because MACs typically are highly negotiated, we expect the “target-friendliness” of a MAC clause to approximate the bargaining power of the parties. For example, the Triad transaction occurred during a very competitive seller’s market; Wyeth occurred during a period of slower M&A activity; and Sun Coast was a distressed target being acquired by a much larger party.

(2) **Exceptions**—Exceptions (or carve-outs) are events that, notwithstanding the occurrence of a change that would otherwise be material and adverse, do not constitute MACs. Typical exceptions include the following: economic changes; industry conditions; actions required by the agreement; announcement of the transaction; war or terrorism; changes in law; changes in generally accepted accounting principles (GAAP) or other governing accounting policy; and matters disclosed to or known by the buyer. Carve-outs demonstrate how MACs are risk allocation tools because each relates to events outside the control of the target; i.e., the target posits that, by entering the transaction, the buyer assumed the “risk of loss” for macroeconomic or industry-wide events, as well as events that result from the agreement itself. Unless economic changes are included as an exception, a MAC theoretically may be found to exist merely as a result of the economy’s having deteriorated since the execution of the definitive agreement.

Note that Wyeth and Triad are substantially similar in this respect, both excepting “macro” changes caused by the market or economy, industry changes, changes in law, changes in GAAP, etc. Each also excludes any changes caused by the agreement itself from constituting a MAC—the identity of the parties, compliance with covenants, litigation resulting from the transaction, and the like. These provisions reflect negotiations between parties of relatively equal bargaining power and generally reflect the common formulation of MAC clauses. Sun Coast is a different type of transaction (with parties of unequal bargaining power), and its exception clause contains a rarely seen quantitative exception—financial loss and admission declines less than a given threshold are deemed not to constitute a MAC. No other exceptions are provided.

(3) **Exceptions to Exceptions**—While the “exception” provisions above are common, certain exceptions also are frequently disregarded if they disproportionately affect the target. E.g., “Material Adverse Effect means any event that is materially adverse to the business of the target, other than any event, state of facts, circumstance, development, change, effect or occurrence resulting from changes in general economic conditions, unless such changes would have a disproportionate impact on the target, relative to similar companies.” This result makes sense if we accept as a corollary to the principle described above that the buyer ought not to be able to exit a transaction because of matters beyond the control of the target, unless the target is more affected than its peers—i.e., perhaps the target was less prepared than others in its industry for unanticipated events. Triad and Wyeth follow this standard formulation, but only include “exceptions to the exceptions” for macro topics like economic conditions, industry changes, war, and terrorism.

Typically, the “peer group” against which any disproportionate effect is measured will be the subject of negotiation. Careful definition of the peer group can have an effect on how easy or difficult it would be for the target to be disproportionately affected. For instance, if Triad’s peer group had been simply defined as “hospital operators,” a change affecting for-profit hospitals generally (but not nonprofit hospitals, such as a tax change) or affecting Triad’s largest markets, but not other markets, it might have been easier to find a “disproportionate effect” on Triad than with the language as written.

**The Current Law on MACs**

The latest MAC case to be decided in Delaware is the *Huntsman* case. In that case, after Hexion agreed to buy Huntsman, Huntsman’s business deteriorated.10 Hexion sued for a declaratory judgment that Huntsman had experienced a MAC.11 The Huntsman court summarized the current state of Delaware MAC law as follows:
For purposes of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earning power over a commercially reasonable period, which one would expect to be measured in years rather than months. A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence. The ubiquitous material adverse effect clause should be seen as providing a “backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer.” This, of course is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. Rather it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future.

While refusing to consider Huntsman’s failure to meet projections because the merger agreement expressly provided that Hexion was not relying on projections, the court acknowledged that expected future performance of a target is relevant to a MAC analysis. The Huntsman court, in finding that the change was not material enough to constitute a MAC, noted that “in only one of Hexion’s three views of future operating performance of Huntsman at the time of signing did Huntsman perform better in 2009 than it is presently expected to by analysts.”

As in Huntsman, in the 2007 Tennessee case of Genesco v. Finish Line, the target’s performance deteriorated after execution of a definitive agreement and the acquiring company asserted the existence of a MAC. Genesco argued that the decline in earnings was a “blip” consistent with Genesco’s historical trend of short-term declines and rebounds. The court found that a MAC had occurred, but ruled that “the decline in performance was due to general economic conditions,” and fit into the carve-out.

Unlike the Huntsman court, the Genesco court viewed the carve-out analysis as part of the analysis of determining whether or not a MAC had occurred. The Genesco court also found that “the inclusion of a provision in the Merger Agreement that Genesco has the opportunity to attempt to cure an MAE by December 31, 2007, is an acknowledgement by the parties that in the context of this merger an MAE can occur in three or four months.”

The Delaware case of Frontier Oil v. Holly involved litigation liability and a MAC in a representation. The court found that the mere existence of a lawsuit would not lead a reasonable person to expect a MAC, unless it is likely to produce adverse results. The court considered the forward-looking basis of the MAC clause in the merger agreement and concluded that the litigation must be viewed as material from the longer-term perspective of a reasonable acquirer before it would constitute a MAC. The court found that a reasonable estimate of the cost of defense was in the range of $15 million to $20 million, and that Frontier could absorb these costs and would not be reasonably likely to suffer a MAC.

In IBP, a Delaware case involving the acquisition of International Beef Processors by Tyson Foods, the court examined a broadly drafted MAC clause, but did not find a MAC and ordered specific performance. The court found that a general economic or industry downturn is not a MAC, even though the document did not include such a carve-out, because a strategic buyer should be concerned with the long term financial performance of the target, and not a “short-term ‘blip’ in earnings” in a business known to be cyclical. Concluding that the case was simply a result of “buyer’s regret,” the court also found that MAC clauses only apply to unknown adverse changes, noting that the due diligence materials included information about the very issues that the buyer claimed constituted a MAC.

Conclusion

Revisiting the hypothetical target and change in regulation described in the introduction, how would it play out, given the current state of the law and our sample provisions? The change to the reimbursement structure would, of course, have to be material, and the change would have to be long term in nature to meet the durational test employed in Delaware. A buyer seeking to assert a MAC might also face difficulties if it knew, when the definitive agreement was signed, that adverse legislation was pending in Congress.

Under the MAC test provided in Sun Coast, the reimbursement decrease would have to constitute a “change . . . that (i) is, or is reasonably likely in the future to be . . . materially adverse to the . . . prospects, results of operations . . . or Assets of [target] . . .” Under the Sun Coast formulation, unless the reimbursement change met specific quantitative hurdles, it could not constitute a MAC. Under the Triad definition, assuming the change would be an “occurrence that is materially adverse to . . . the business, financial condition or results of operations of [target],” the more difficult question is whether the change in reimbursement would fall into the exception of “general changes or developments in the industries in which the [target] operate[s], including general changes in applicable Law across such industries . . .” While Triad includes
“disproportionate effect” language, the peer group is narrowly confined, and a court would have to analyze whether the target was more affected than other “for profit participants” in the target’s industry and in the target’s market.

One thing is certain: nothing is certain for buyers looking to get out of a deal. IBP stated that “simplicity of [MAC clause] words is deceptive, because the application of those words is dauntingly complex.”31 Do not fall victim to using “form” language assuming one size fits all. Analysis of the existence of a MAC will require a facts-and-circumstances review; the Frontier court stated that the “notion of an MAE is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties.”32 We recommend introducing as much detail in drafting as the negotiations permit. The IBP court stated that “[h]ad IBP wished such an exclusion from the broad language . . . IBP should have bargained for it.”33 Our job as transactional lawyers is to identify what is important to our clients and prospectively protect those interests rather than rely on evidence to explain later that we all knew “this” might happen and we all planned for it to be covered as a MAC. Because a change must be major to constitute a MAC, MACs should be the last choice when the wheels have come off; i.e., invoking a MAC clause should be considered only as catastrophic insurance (and with limited coverage at that).34

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Endnotes
2 See Kenneth A. Adams, Understanding “Material Adverse Change” Provisions, M&A LAWYER, at 3, 5, June 2006 (“The defined term “Material Adverse Effect” (referred to here as “MAE”) is used as an alternative to the defined term MAC. MAC works better than MAE in absolute provisions, since it sounds a little odd to refer to an effect, as opposed to a change, not having occurred since a given date.”).
5 Wyeth, Current Report (Form 8-K) at 76 (Jan. 29, 2009).
7 Asset Purchase Agreement, dated as of Dec. 28, 2007, by and among Sun Coast Hospital, Inc., Sun Coast Imaging Center, LLC and Largo Medical Center, Inc. at 7, available at https://ecfr.frm.uscourts.gov/doc/046016471869.
10 Id.
11 Id.
12 Id. See Andrew C. Eken, Note, Rethinking the Material Adverse Change Clause in Merger and Acquisition Agreements: Should the United States Consider the British Model?, 82 S. CAL. L. REV. 291, 315 (2009) (“[t]he clear message from the Hexion opinion is that it will be very difficult for a buyer to successfully invoke a MAC clause to refuse to close a transaction.”); Gregory V. Varallo and Blake Rohrbacher, Lessons from the Meltdown: MAE Clauses, DEAL LAWYERS, Jan.-Feb., 2009. (“it is now clear that such [MAE] clauses will be interpreted solely as ‘backstop’ provisions designed to deal with only the most profound and unanticipated long-term changes in corporate fortunes.”).
15 Id. at 30.
16 Id.
17 Id.
18 Id.
19 Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005) (“In substance, Frontier represented to Holly that the Beverly Hills Litigation would not have an MAE and would not reasonably be expected to have an MAE.”).
20 Id. at 35-36.
21 Id. at 36.
22 Id.
24 Id. at 66.
25 Id. at 67.
26 Id. at 22.
27 Id.
28 Id.
29 See Sun Coast, supra note 7.
30 Triad Hospitals, supra note 6.
31 In re IBP, Inc. Shareholders Litig., 789 A.2d at 65.
32 Frontier Oil Corp., 2005 WL 1039027, at 34.
33 In re IBP, Inc. Shareholders Litig., 789 A.2d at 66.