R K & O RICHARDS KIBBE & ORBE LLP ONE WORLD FINANCIAL CENTER NEW YORK, NEW YORK 10281-1003

November 8, 2007

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Nicholas Whitney and Doug Plante

RE: Incremental Loan Facilities: Key Provisions

Incremental loan facilities (also known as accordion features) permit a Borrower to borrow additional term loans[1] from existing or new term loan lenders under the Credit Agreement so long as certain conditions are satisfied. When negotiating Credit Agreements that contain incremental loan facilities, lenders should carefully consider certain key provisions.

Term and Pricing Restrictions of New Term Loans

Lenders first need to focus on whether the Credit Agreement restricts the interest rate of any new term loans that may be borrowed under the incremental loan facility. Credit Agreements fall into three categories with respect to the interest rates that may be charged for new term loans: (1) no restriction; (2) a restriction on an increase in the interest rate, sometimes within a margin; and (3) a restriction on the overall yield for the new term loans, which includes fees and original issue discount ("OID").

In the current market, an overwhelming majority of Credit Agreements with incremental loan facilities do not contain any restrictions on the interest rate charged on the new term loans. These facilities simply state that the Borrower and the new lenders will determine the interest rate of the new term loans at the time they are borrowed. In a rising interest rate environment, incremental loan facilities with no restriction on the interest rate charged on the new term loans can cause an economic impact on the existing lenders in the Credit Agreement. In addition to receiving a lower return than the new lenders, a new term loan that has a higher interest rate than an existing term loan may cause the trading price of the existing term loans in the secondary market to decrease.

Provisions in Credit Agreements designed to protect existing lenders by placing restrictions on the interest rates charged on new term loans are often referred to as Most Favored

[1] New revolving commitments will be on the same terms as the existing revolving commitments, including with respect to pricing. In addition, the new revolving commitment lenders usually will be required to ratably purchase outstanding revolving loans so that the new revolving commitment lenders and the existing revolving commitment lenders will share ratably in all outstanding revolving loans. Note that while pricing is not an issue for existing revolving lenders, the other considerations set forth in this memo with respect to dilution of lenders' interests and financial covenant compliance apply to both existing revolving lenders and existing term lenders.

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Nation ("MFN") provisions. MFN provisions vary from Credit Agreement to Credit Agreement. One type of MFN provision restricts any new term loans borrowed by the Borrower from being priced at a higher interest rate than the existing term loans, unless the interest rate on the existing term loans is increased to the higher interest rate. A less restrictive type of MFN provision permits the new term loans to be priced at a higher interest rate than the existing term loans up to a margin. The less restrictive MFN provisions typically provide that if the interest rate for the new term loans is higher than the interest rate for the existing term loans by a margin of more than 25-50 basis points, then the interest rate for the existing term loans must receive a corresponding increase in order to maintain the margin.

Even when a Credit Agreement contains an MFN provision, the Borrower may be able to pay more to the new lenders and circumvent a narrowly-drafted MFN provision by providing OID or up-front fees to effectively provide the new lenders with a better return. Existing lenders can prevent the Borrower from circumventing an MFN provision by drafting the provision broadly so the calculation of the interest rate relating to the new term loans includes (i) any OID, (ii) fees and (iii) any other consideration to be paid to the new lender associated with the issuance of the new term loans. By including the OID, fees and other consideration in the calculation of the interest rate, the MFN provision will more effectively limit the total yield that the new lenders can receive on the new term loans.

Dilution of a Lender's Interest in the Facility

A true incremental loan facility is an uncommitted facility that the Borrower only has access to if lenders are willing to provide the loans. In the current market, only a small minority of Credit Agreements require the Borrower to first offer the new term loans to the existing lenders. More often, incremental loan facilities give the Borrower absolute freedom to select and allocate the incremental loan facilities among any group of participating lenders. Sometimes these participating lenders are existing lenders, but unless the Credit Agreement requires that the incremental loan facilities be first offered to the existing lenders on a pro rata basis, the Borrower has the discretion to select the lenders who provide the incremental loan facilities, and those lenders may or may not be part of the existing lender group. While the selection process may be subject to the Administrative Agent's consent, existing lenders need to be mindful that their pro rata share of the facility will be diluted when the incremental loans are added to the facility. Moreover, the incremental loan facility will share the same collateral pool with the existing loan facility, reducing the collateral coverage available to the existing lenders.

Pro Forma Compliance with the Financial Covenants

Finally, lenders should consider the effect of a borrowing under an incremental loan facility on the Borrower's financial covenants. Typically, the Borrower must be in pro forma compliance with the financial covenants contained in the Credit Agreement in order to

access the incremental loan facilities. Sometimes, however, Credit Agreements require compliance with the financial covenants at tighter levels than those levels applicable in the Credit Agreement at the time of, and after giving pro forma effect to, the borrowing under the incremental loan facility (for example, a leverage ratio 0.25 tighter than the applicable leverage ratio). As a business matter, lenders should consider whether requiring the Borrower to satisfy the tighter financial covenants is appropriate given the fact that by borrowing under the incremental loan facility, the Borrower will be increasing the amount of debt on its capital structure. In the current market, a majority of credit agreements do not require pro forma compliance with financial covenants at tighter levels than those levels applicable in the Credit Agreement.

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This memorandum has been prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest. It is not intended to be full description of all material terms of accordions and incremental loan facilities. The information provided is therefore general, and it should not be considered legal advice.

Should you have any questions regarding accordions and incremental loan facilities, please do not hesitate to contact us:

Nick Whitney – 212-530-1956 (nwhitney@rkollp.com)
Doug Plante – 212-530-1804 (dplante@rkollp.com)