Avoiding The Prisoner's Dilemma: Invest Where There Are Fewer Jails

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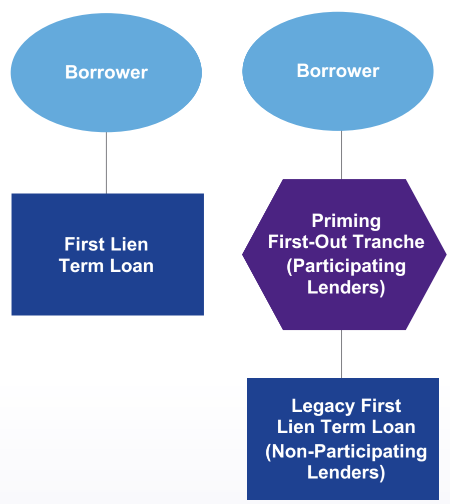
Liability Management Exercises ("LME") continue to get significant press and seem to be an agenda item in most conversations with allocators. 9fin[1] defines a liability management exercise as "any corporate action involving the modification, exchange, or restructuring of a company's debt obligations. These transactions represent everything short of an in-court restructuring and can range from simple document amendments to complex debt exchanges."[2]

Based on the definition above, most off-track portfolio amendments would qualify as an LME, but the most attention-grabbing headlines are reserved for instances which include the presence of "lender on lender" violence, naturally at the detriment of a lender minority. The most common structure remains an uptier transaction, popularized by Serta in 2020, although numerous variants have developed.

These transactions involving creditor infighting typically occur in a distressed scenario, where loans are viewed as undercollateralized, and where the borrower is looking for liquidity and/or time. A transactional Sponsor along with a participating lender majority agree to amend the credit agreement in a beneficial manner for the borrower. Those participating lenders do so while excluding entirely, or pressuring, a "jailed" minority of lenders into a prisoner's dilemma. The minority lenders are forced to accept terms less favorable than terms accepted by the majority or they face even more dire terms and a challenging and expensive litigation process if the minority were to challenge the transaction. The result for the minority is its loan-to-value increases as majority lenders springboard ahead of the minority in the waterfall.

While lender-on-lender violence has historically been concentrated in the broadly syndicated loan market (BSL) typically due to looser documentation, no financial maintenance covenants, internal asset transfer mechanisms outside the creditor group such as unrestricted subsidiaries, and a liquid secondary market, NXT Capital recognizes that the middle market is not immune to LME that can potentially disadvantage minority lenders.

FIGURE 1:
Pre-Transaction Structure | Post-Transaction Structure



[1] 9fin is a financial technology platform providing data and analytics across global debt capital markets.
[2] 9fin: A crash course on LMEs: Lesson one dated November 5, 2025.

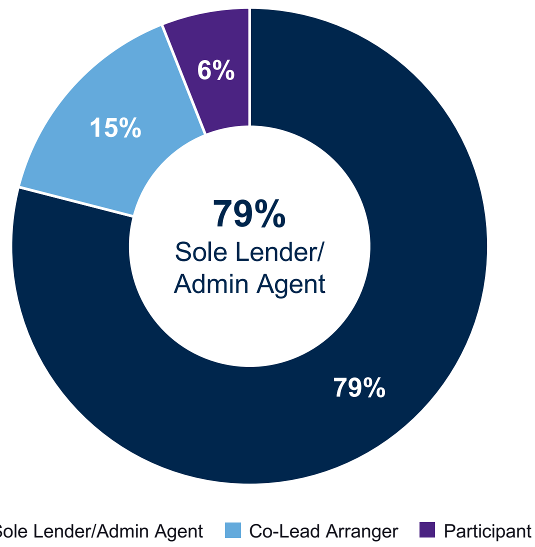
How do you attempt to avoid the prisoner's dilemma?

NXT Capital's view—stay out of jail: We believe being a part of the majority lender set is critical to staying out of LME jail. NXT Capital accomplishes this by taking a lead position in the vast majority of our deals (see figure to the right). To this end, NXT Capital's consent was a required vote to amend the credit agreement in 89.5% of transactions closed in the last two years. This position, along with smaller bank groups, (an average ~3 lenders/facility across the NXT Capital portfolio vs. +15 in the BSL market) requires us to be invited to the negotiation table. This dynamic means the opportunity for a coercive LME is greatly reduced and a consensual deal is the likeliest outcome.

The next tactic for staying out of LME jail is NXT Capital's credit first approach that has us executing deals with borrowers that can service their debt at close and through the projection period, including in a downside case. This is another factor that helps decrease the likelihood that an LME solution to a liquidity need is required.

FIGURE 2:

NXT Capital Role



Finally, every deal we close has a financial covenant which provides us the opportunity to be back to the table before liquidity has degraded to a point where the probability of an LME increases. The time of an initial financial covenant default is an occasion to tighten documentation to prevent a future LME, should company performance continue to decline. When circumstances dictate, NXT Capital looks to advocate that initial amendments include terms specifically intended to prevent non-pro rata treatment of lenders in the same class.

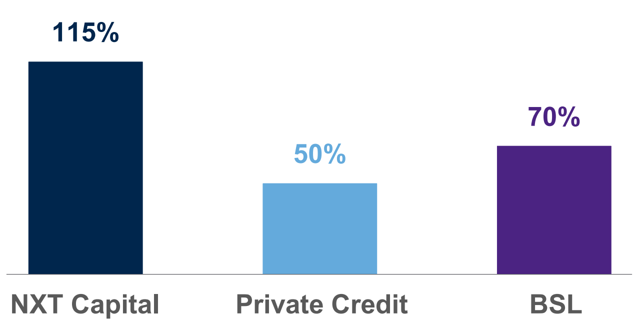
If, after all of this, you do find yourself in jail, it helps to know the warden. NXT Capital has longstanding sponsor relationships in the lower middle market which often include multiple transactions over several years amongst parties. Contrasting these relationships with the often-transactional nature of the BSL market or non-sponsored deals, we believe the odds of a company disadvantaging a minority is greatly diminished in a deal where the sponsor is connected to that lender in multiple other transactions.

Given the dynamics discussed above, NXT Capital has not been the victim of an LME. Further, NXT Capital has successfully navigated distressed situations and we believe possess significant experience working with all constituents to effectuate solutions in a consensual manner, designed to not inflict violence on creditors of the same class, resulting in realized outcomes that compare favorably to industry recovery benchmarks.[4]

FIGURE 3:

First Lien Recovery Trends[3]

- Recently, recovery rates have averaged ~50% and 70% for broadly syndicated loans
- Conversely, NXT Capital realized on 6 defaulted deals since January 2023, each achieving recovery rates over 85%
- Weighted accuracy recovery rate of 115%



[3] "Recovery Rate" is calculated as Recovery Amount divided by Defaulted Loan Amount. "Recovery Amount" is calculated as Realized Recoveries plus Unrealized Recoveries. "Realized Recoveries" means all cash principal payments actually received in respect of Defaulted Realized Loans plus, after the date of Default, all cash interest and fees actually received in respect of Defaulted Realized Loans. "Unrealized Recoveries" means the amount of Defaulted Unrealized Loans minus Total Write-offs and Specific Reserves in respect of such Defaulted Unrealized Loans. NXT Capital refers to new platforms from 1/1/23 – 12/15/25.

[4] Private Credit refers to Cliffwater 2025 Q2 Report on US Direct Lending. BSL information sourced from KBRA/ DLD.