

# Riess and Lauer in Practical Law Finance: Lending in the Multi-Unit Restaurant Sector

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**PRACTICES** Finance, Franchise and Distribution, Leveraged Financings

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In an article for *Thomson Reuters' Practical Law Finance*, Haynes Boone Charlotte Office Managing Partner [Justin Riess](#) and Partner [Rob Lauer](#) examine loan financing arrangements for operators of U.S. restaurant franchises, exploring the issues that may arise in a loan transaction involving a multi-unit restaurant operator.

Read an excerpt below.

Annual revenue in the domestic multi-unit restaurant business by some estimates exceeds \$900 billion and multi-unit operators dominate the restaurant franchise sector. The industry includes operators of a handful of locations all the way up to largescale businesses operating hundreds of locations under multiple brands all over the country. This Practice Note, offering a perspective that is geared towards corporate finance attorneys, focuses on medium to large-scale operators of restaurant franchises, and examines important aspects of loan financing arrangements for these businesses. Large organizations in general may have access to a variety of sources of public and private capital, but commercial loans are a key source of financing for many middle-market companies in the multi-unit restaurant business.

Although not as common in multi-restaurant transactions, the Small Business Administration's SBA loan program is another source of financing for franchisees. The SBA has off and on had a franchise directory listing franchisors that the SBA had vetted for minimum compliance with the SBA's affiliation requirements, which lenders have long relied upon to fast-track franchise loans.

The principal considerations that a finance attorney working on a loan transaction involving a multi-unit restaurant operator may encounter include:

- The borrower's organizational characteristics.
- Business due diligence, focusing on the franchise relationship between the borrower and the franchisor, real estate, and business operational matters.
- Collateral securing the loan obligations.
- The method of calculating the borrower's earnings, including accounting for earnings related to minority interests in the business, as well as permitted adjustments to the borrower's EBITDAR measure of earnings.
- Loan covenants and default cure rights.

## **Borrower's Structure**

There are many types of borrowers operating within the multi-unit restaurant sector, and one of the foremost preliminary concerns for attorneys working on loan transactions in this sector is to understand the borrower's organizational structure.

A preferred structure from a lender's perspective may be a borrower that is organized so that each of its locations is operated by a separate wholly owned subsidiary, because of the simplicity of the structure. However, less tidy structures are common in the industry with some companies having no consistent approach across the whole business.

Businesses that acquire other multi-unit operators, for example, may have irregular ownership structures, reflecting the different approaches of the original businesses. Minority interests are also common in the restaurant industry, particularly with smaller businesses. The borrower's ownership structure will impact how the loan documents are prepared, and minority interests must be addressed carefully in the measurement of the borrower's earnings for covenant purposes, and in loan covenants permitting dividends and distributions.

Private equity ownership of businesses in the sector is widespread, and sponsors generally favor streamlined structures. Sometimes the occasion of negotiating a new credit facility is an opportunity for a borrower to make changes to its corporate structure to eliminate any organizational peculiarities that might raise concerns for lenders. It is important for the finance attorneys to have a clear idea of how the borrower is organized and any changes that are required before closing, to ensure that the transaction documents properly reflect the negotiated deal.

## **Lending Due Diligence**

In a lending transaction, the due diligence exercise forms the basis of the lender's assessment of the borrower's creditworthiness and informs the lender's decision about how much to lend and what terms. Lenders sometimes approach due diligence differently in individual cases, with varying levels of scrutiny paid to particular aspects of a borrower's business. Finance attorneys may not be heavily involved in all aspects of the business due diligence, but it is important for them to understand the full scope of the exercise and the principal findings. Specific aspects of lending due diligence that a finance attorney typically sees in a loan deal where the borrower is a multi-unit restaurant operator involve:

- Financial and accounting due diligence (see Financial Due Diligence).
- The franchise agreement under which the borrower is franchisee (see Franchise Agreement Due Diligence).
- The strength of the borrower's management team and business plan (see Business Due Diligence).
- The borrower's business locations and growth potential (see Real Estate Due Diligence).
- Other operational considerations that are relevant to the restaurant industry (see Industry Due Diligence).

[Read the full article here.](#)