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Authors:

[Keely C. Downs](#)

How HUD Borrowers Can Bring Additional Financing to Their Capital Stack

The U.S. Department of Housing and Urban Development (HUD), has long provided a great option for multifamily borrowers: long-term, fixed-rate mortgage insurance programs such as the 221(d)(4) program for new construction and substantial rehabilitation and the 223(f) program for acquisition or refinancing of existing assets, both of which offer up to 40-year amortization, non-recourse debt and competitive interest rates. HUD loans have long been thought of as protecting borrowers from high-interest-rate risk and other volatility experienced in conventional real estate finance markets.

Yet even with the stability of HUD-insured loans, multifamily borrowers are not immune from today's challenging market environment. Inflationary pressures, occupancy challenges, rising operating costs and rising construction costs have created conditions in which borrowers may find themselves needing to bring in additional equity after their HUD-insured loan has closed.

HUD regulations limit how equity and subordinate financing can be introduced to the capital stack, so borrowers often face the reality of trying to fit their needed capital infusion into the strict HUD-required regulatory framework. While it can be challenging to follow all the rules, HUD borrowers do have options for accessing additional equity and debt.

What's Driving the Need for Additional Capital?

For borrowers utilizing HUD's Section 221(d)(4) program, cost overruns have become a significant challenge, and HUD-required contingency reserves are sometimes insufficient in the face of rising building materials costs because of tariffs, labor shortages and supply chain disruptions. Similarly, market challenges can lead to delays that increase construction schedules, prolong interest and carry costs and Government National Mortgage Association (GNMA) delivery delay fees. After construction, borrowers may

encounter funding gaps during lease-up. HUD requires working capital escrows and operating deficit reserves for 221(d)(4) projects, but these do not always cover shortfalls.

In addition to construction costs, taxes and insurance are also a concern. The steep increase in insurance premiums and property tax assessments are plaguing multifamily borrowers across the country, significantly reducing NOI and testing debt service cover ratios. Borrowers may even find themselves close to tripping loan covenants. Sponsors may need to contribute to fund shortfalls, reserves or finance upgrades that reduce operating costs.

Competitive pressures and capital improvements also drive development costs. In many markets, multifamily competition is intensifying. Tenants increasingly demand upgraded finishes, energy-efficient appliances and attractive community amenities. To remain competitive, owners often need to make additional capital investments beyond what was originally underwritten.

HUD loans restrict the introduction of new secured debt without prior approval, making equity injections the most practical way to fund these improvements. In today's environment — where residents have more options and are price-sensitive — investing in upgrades can be the difference between high vacancy and stable occupancy.

Options to Infuse Equity, Obtain Secondary Debt

HUD permits the use of preferred equity in multifamily projects, but only under strict conditions designed to protect the FHA-insured first mortgage.

Security restrictions: Ownership interests in the borrower entity itself cannot be pledged without HUD's prior consent, and no Uniform Commercial Code filings or liens from secondary debt may encumber project assets. Investors may instead pledge interests in upstream ownership entities or rely on outside collateral unrelated to the project. Security interests in distributions are permitted, since they do not compromise the project directly.

Cash flow and distributions: HUD requires that all distributions come solely from "Surplus Cash," defined as cash available after

project expenses and reserves are satisfied. Distributions for projects insured before 2022, and many projects insured after 2022 can only occur semi-annually, following an auditor's certification. This rule makes monthly payment obligations unworkable; any such arrangement must be restructured, often through funding an external account from non-project sources.

Remedies and control: Investor remedies that shift control are subject to HUD's modified transfer of physical assets (TPA) approval. For example, replacing the manager or transferring more than 50 percent ownership cannot occur without HUD's written consent. Agreements often include default provisions granting the investor certain rights, but these should be explicitly limited so as not to violate HUD loan documents. HUD is currently considering rule changes that would allow for pre-approval of preferred equity investors to exercise step-in rights if that becomes necessary.

In sum, while HUD does allow preferred equity, it must be carefully structured. The equity must meet the following rules: no liens on the project, distributions can be made only from surplus cash on a semi-annual basis (for most projects) and investor remedies are conditional on HUD approval.

Secondary Debt Options

HUD's Section 241(a) program provides an FHA-insured supplemental loan for additions, repairs or improvements to an existing insured project. The loan may be originated by the first-lien FHA lender or a new FHA lender and is usually coterminous with the first mortgage if more than 25 years remain.

Where less time remains, HUD may approve a separate amortization of up to 40 years, subject to economic life. The loan is cross-defaulted with the first mortgage and treated as a single project for capital-needs planning. In practice, 241(a) offers HUD's "on-platform" method to add leverage for capital improvements without disturbing the original financing.

Property Assessed Clean Energy (PACE) financing allows owners to fund energy efficiency and renewable improvements through a special tax assessment repaid with property taxes. HUD permits

PACE assessments on FHA-insured projects if strict conditions are met: only the delinquent installment (not the full balance) can be accelerated, HUD must receive notice of defaults, and improvements must demonstrate a savings-to-investment ratio of at least one-to-one.

Combined debt and PACE must remain within HUD's loan-to-value limits. Properly structured, PACE gives borrowers an additional tool to finance sustainability upgrades without impairing the FHA-insured first mortgage. Unfortunately, at this point, HUD has only approved the PACE programs in Connecticut, Washington, D.C., Colorado, Michigan, Texas, most of Maryland and most of California, however other states should be coming online soon.

HUD allows certain forms of subordinate debt in FHA-insured projects, with different rules under Section 223(f) and 221(d)(4). In 223(f) loans, both public and private subordinate financing may be permitted if it is fully subordinate, utilizes HUD-required forms, payable only from surplus cash and within loan-to-value limits.

Mezzanine debt can be structured as equity pledges to upstream entities (a parent company), but remedies are limited, and transfers require HUD approval. For 221(d)(4) loans, rules are stricter: Private subordinate debt is generally prohibited, though public financing may be allowed. These constraints ensure secondary financing never undermines the priority or stability of the FHA-insured mortgage.

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