

MEMO

TO: PAT ALLEN with the Greater Smoky Mountain Association of Realtors®

FROM: DEANNA COOPER, attorney for the Tennessee Association of Realtors®

DATE: September 8, 2008

RE: Septic Disclosure

Septic issues and disclosures have become a major issue in Tennessee recently, particularly in determining the number of bedrooms that a home has and how that is determined. As a result, the legislature and the Tennessee Real Estate Commission have enacted numerous laws and rules to address this issue. This memo analyzes the changes in the law and the obligations and responsibilities of Realtors® concerning septic and septic disclosures.

In 2006, the Tennessee Legislature added a provision to the Consumer Protection Act which addressed septic systems. This act drastically changed septic disclosures in an effort to protect homebuyers from purchasing homes with inadequate septic systems. That law had several provisions which directly impacted real estate agents across the state. The statute specifically prohibited knowingly advertising a property as having more bedrooms than it was permitted to have. It also put agents on what is known as constructive notice. This means that the agent was deemed to have knowledge of what the recorded permit stated, even if they had never seen it before. This created a huge uproar across the state. Agents and county officials had great difficulties in keeping up with the demand for permits since it was now required that ANY home which was on septic had to

have the permit pulled before it could be advertised to sell. As a result of these problems, the Legislature changed the law in 2007.

Prior to addressing these changes, it is important to understand several provisions of the Consumer Protect Act (“TCPA”). First, it applies to many different industries, not just real estate. One of the purposes of the Act is “To protect consumers and legitimate business enterprises from those who engage in unfair or deceptive acts or practices in the conduct of any trade or commerce in part or wholly within this state” Tenn. Code Ann. § 47-18-102(2). As a result, there are some very strict penalties for violating it. First, if one engages in any prohibited activity, he can be charged with a Class B misdemeanor (a crime). This means that he could be prosecuted both criminally and civilly. On the civil side, if someone is found to have violated the TCPA, then they could face numerous penalties in addition to just the standard damages. One is referred to as Treble Damages. This means that the judge can order that ANY award of damages resulting from violation of the TCPA is multiplied by three. In addition to this “extra” penalty, the judge can also order that the violator pay the wronged party’s attorney fees and court costs. This could GREATLY increase the total judgment award.

In 2007, the Tennessee Legislature realized that there were problems with the new septic provision of the law. Both agents and the county workers in charge of the septic permits were having great difficulties with the law as it was written. As a result, the law was changed. Below you will find a copy of this portion of the statute in its present form:

Tenn. Code Ann. § 47-18-104(b)(42):

(42) (A) Knowingly advertising or marketing for sale a newly constructed residence as having more bedrooms than are permitted by the newly constructed residence's subsurface sewage disposal system permit, as defined in Section 68-221-402, unless prior to the execution of any sales agreement the permitted number of bedrooms is disclosed in writing to the buyer. The real estate licensee representing the owner may rely upon information furnished by the owner.

(B) If a newly constructed residence is marketed for sale as having more bedrooms than are permitted by the subsurface sewage disposal system permit and no disclosure of the actual number of bedrooms permitted occurs prior to the execution of a sales agreement, then the buyer shall have the right to rescind the sales agreement and may recover treble damages as provided in Section 47-18-109.

(C) A subsurface sewage disposal system permit issued in the name of the owner of a newly constructed residence shall serve as constructive notice to that owner of the newly constructed residence for the purpose of establishing knowledge as to the number of bedrooms of the newly constructed residence for the purpose of finding a violation of this subdivision. A real estate licensee representing such owner must have actual knowledge transmitted from such owner to said real estate licensee to be in violation of this subdivision.

These changes mean that this portion of the TCPA only applies to new construction. In addition, it provides several protections for agents. Agents are no longer on constructive notice. This means that they must have actual knowledge (see the permit or be told what is on it), in order to violate the provision. In addition, it states that the agent can rely upon what the seller (usually the builder in these cases) tells them regarding the number of bedrooms. It is no longer required that the permit be pulled every time.

However, this is not the end of the discussion. This does NOT mean that an agent can advertise a piece of property with more bedrooms than it is permitted to have if he has knowledge of what the permit states. There are

several other provisions of the law that cover this area as well. Below, I will outline several ways in which an agent could be punished for this type of behavior. These fall under the TCPA, the Broker's Act, and the NAR Code of Ethics.

First, we will continue our discussion of the TCPA. As stated earlier, there are many different prohibited activities under this statute. There are several provisions other than the "septic" portion that a savvy attorney can use to make a case against an agent. First, there is a general prohibition which states that "[u]nfair or deceptive acts or practices affecting the conduct of any trade or commerce shall constitute unlawful acts or practices and are Class B misdemeanors." Tenn. Code Ann. § 47-18-104(a) It goes on to state that it is a violation to "[e]ngag[e] in any other act or practice which is deceptive to the consumer or to any other person". Tenn. Code Ann. § 47-18-104(b)(27). This is a general catch-all clause. In my opinion, if an agent knows that a home is only permitted to have 3 bedrooms but advertises that the home has 5 bedrooms, this would constitute an act that is deceptive to the consumer. If found guilty of violating this provision of the TCPA, the agent could still be in jeopardy of being subjected to treble (triple) damages, attorney's fees, and possible criminal charges.

The next issue is the Broker's Act. The Broker's Act has several provisions within it that prohibit an agent from misleading the public in their advertising. Pursuant to Tenn. Code Ann. § 62-13-312(b), it is a violation to "Mak[e] any substantial or willful misrepresentation"; to "Pursu[e] a continued and flagrant course of misrepresentation or making false promises through affiliate brokers,

other persons, or any medium of advertising, or otherwise” and to engage in “misleading or untruthful advertising.” Tenn. Code Ann. §62-13-312(b)(1), (3) and (4). A court could find that knowingly advertising a house as having more bedrooms than it is permitted to have would violate all three of these provisions. In addition, it is my opinion that TREC could also penalize an agent for these actions as well under these same portions of the Act.

Another possible area of concern would be disclosure of adverse facts. Pursuant to Tenn. Code Ann. § 62-13-403(2), a real estate agent is required to “[d]isclose to each party to the transaction any adverse facts of which the licensee has actual notice or knowledge.” Tennessee law defines an adverse fact as “conditions or occurrences generally recognized by competent licensees that have a negative impact on the value of the real estate, significantly reduce the structural integrity of improvements to real property or present a significant health risk to occupants of the property.” Tenn. Code Ann. § 62-13-102(2). A reduction in the number of rooms that would legally constitute a bedroom would be an adverse fact since it would reduce the value of the home.

Finally, in my opinion, a Realtor® could also be in violation of Article 12 of the NAR Code of Ethics. Article 12 states that “Realtors® shall be honest and truthful in their real estate communications and shall present a true picture in their advertising, marketing, and other representations.” To knowingly mislead the public into believing that a property has more bedrooms than it is permitted to have would violate this provision. A local board could penalize a Realtor® for violation of this Article if they found that the Realtor® **KNEW** what the permit

said and yet continued to advertise more bedrooms than were reflected on that permit.

As one can see, this all revolves around the septic permit. Tennessee statute defines a permit as “a written authorization issued by the commissioner licensing one (1) of the following: the construction, alteration, extension or repair of a subsurface disposal system, or the removal and disposal of accumulated wastes from subsurface sewage disposal systems, and including those engaged in such businesses”. Tenn. Code Ann. § 68-221-402(5). The law also puts forth a minimum set of requirements to obtain a permit. One of the requirements is that the property has a disposal field that “contains a minimum of three hundred seventy square feet (370 sq. ft.) of trench bottom area per bedroom.” Tenn. Code Ann. § 68-221-403(c)(6). The Regulations to Govern Subsurface Sewage Disposal Systems set forth by the Department of Environment and Conservation, Division of Ground Water Protection define a disposal field as “the part of a subsurface sewage disposal system that utilizes the soil for absorption and treatment of septic effluent.” Rule 1200-1-6-.01. Therefore, the size of the septic tank is based upon the number of bedrooms that the system can accommodate. Unfortunately, there is not a standardized definition of bedroom to which one can point. However, the size of the septic system DOES dictate how many bedrooms a house technically has under the law. If the permit is for two bedrooms, then the home has two bedrooms not four. To be correct in advertising, an agent could state that it has two bedrooms, an office and a sitting room. **THEY SHOULD NOT** advertise the home as having four bedrooms even though it appears that two of these rooms are bedrooms.

I have not been able to find a case which mirrors this particular set of circumstances exactly, but it is clear from the case law that agents are not permitted to misrepresent information to buyers. There are two basic common law claims could be made in addition to those above. These are negligent misrepresentation or intentional (or fraudulent) misrepresentation. The Supreme Court has stated the elements of a claim of intentional or fraudulent misrepresentation as follows:

When a party intentionally misrepresents a material fact or produces a false impression in order to mislead another or to obtain an undue advantage over him, there is a positive fraud. The representation must have been made with knowledge of its falsity and with a fraudulent intent. The representation must have been to an existing fact which is material and the plaintiff must have reasonably relied upon that representation to his injury.

Gardner, 2004 Tenn. App. LEXIS 813, *12-13 (*quoting* First Nat. Bank of Louisville v. Brooks Farms, 821 S.W.2d 925, 927 (Tenn.1991)). If an agent ***KNOWS*** that the house is permitted to have 3 bedrooms but advertises for 5 bedrooms, they could very well satisfy the above definition. First, the agent knew the home only had 3 bedrooms. His statement that the home had 5 bedrooms was intentional and it was false. The reason for this statement was so that the home would be more attractive and would fetch a higher price. This is to the advantage to the seller and the agent. The statement was that of fact and if the buyer relied upon that statement to his detriment, you have a textbook example of intentional misrepresentation (i.e., ***FRAUD***).

The next possibility would be negligent misrepresentation. The Tennessee Supreme Court defines negligent misrepresentation as:

One who, in the course of his business, profession or employment, or a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon such information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Volunteer Investments, Inc. v. Feller Brown Realty & Auction Company, 2001 Tenn. App. Lexis 622, 11-12, citing Tartera v. Palumbro, 453 S.W.3d 780 (Tenn. 1970) This goes hand in hand with the Broker's Act requirement that all agents "diligently exercise reasonable skill and care in providing services to all parties to the transaction." Tenn. Code Ann. § 62-13-403(1). This would possibly be applicable in a situation in which the agent did NOT know the number of bedrooms that a home was permitted to have. In my opinion, it is not necessary for all permits to be pulled in all transactions involving septic. However, to be safe, a principal broker can require that this be done in all homes involving septic. That being said, there are times in which a reasonable agent should **ALWAYS** pull a permit. This would be in situations such as one in which there were bedroom additions made to the house of which the agent is aware. A prudent agent would realize that this may mean that the septic permit does not support these additional bedrooms. It would be possible under the correct factual set of circumstances for a court to determine that the agent was negligent in not taking the extra steps to determine the number of bedrooms that the home is permitted to have.

Please bear in mind that this is a new area and cases are filed all the time concerning this area of the law. I would strongly advise against advertising a home as having more bedrooms than it is permitted to have (provided that the

agent has this knowledge). This would include any MLS advertisements that would fall into the following category: Home has a permit for 3 bedrooms. Agent knows about permit and the number of bedrooms provided. Home actually has 5 rooms that could be considered “bedrooms”. In the MLS, agent put in 5 bedrooms, then in remarks section indicates that the home is only permitted for 3 bedrooms. I WOULD STRONGLY RECOMMEND THAT THIS NOT BE ALLOWED. One, the remarks section may not be visible to everyone. Second, these rooms are NOT recognized as bedrooms under Tenn. Code Ann. § 68-221-403(c)(6). Instead, this home should be advertised as having 3 bedrooms and then refer to the other rooms as bonus rooms, offices, sitting rooms, etc. – just not bedrooms.