

## In This Issue:

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In a matter of first impression, the Ninth Circuit Court of Appeals held that employers that do not take a tip credit against the federal minimum wage may pool tips and allow all hourly employees, including employees who do not have in-person interaction with guests, to share in the “tip pool.” In this down economy, the court’s approval of greater flexibility in staff compensation should be a relief for hospitality and tourism employers.

## The Ninth Circuit Clears the Way for Tip-Pooling Arrangements

By Laurent R.G. Badoux and Jennifer L. Mora

Hospitality and tourism employers should greet news of a favorable Ninth Circuit Court of Appeals decision with joy and a big sigh of relief. In *Cumbie v. Woody Woo, Inc.*, No. 08-35718 (Feb. 23, 2010), the court confirmed that the Fair Labor Standards Act (FLSA) allows employers that do not take a tip credit against the federal minimum wage to pool tips and allow *all* hourly employees – not just those who have in-person interaction with guests – to receive a portion of the “tip pool.” The opinion brings clarity (and much needed legal support) in an area where confusion as to the rule of law and expensive litigation had caused uncertainty and reticence.

The Ninth Circuit’s holding confirms that employers who pay employees without taking a tip credit against the federal minimum wage can implement a tip-sharing agreement to allow tips to be divided among all hourly employees working in the establishment even if they do not interact personally with guests. At a time when the tourism and hospitality industry is feeling the pressure of razor-thin profit margins in a down economy, the court’s approval of greater flexibility in distributing proceeds of gratuities should be a welcome development.

### Café Requires Its Servers to Contribute Their Tips to a Tip Pool

In *Cumbie*, the plaintiff worked as a waitress at Vita Café in Portland, Oregon, operated by Woody Woo, Inc. Vita Café paid its servers at or above Oregon’s minimum wage, which at the time was \$2.10 more than the minimum wage under the FLSA. In addition, Vita Café paid to the servers a portion of their daily tips. Although Vita Café also employed kitchen staff, such as dishwashers and cooks, the servers were the only employees who worked directly with customers and customarily received tips. Vita Café required its servers to contribute their tips to a “tip pool,” which was then distributed to all employees. Between 55% and 70% of the tips were paid to the kitchen staff, and the remaining amount (30% to 45%) was paid to the servers in proportion to their hours worked. Vita Café did not use any of the tips to offset the employees’ minimum wage

rate. The plaintiff ultimately filed a putative collective and class action against Vita Café alleging that its tip-pooling arrangement violated the minimum wage provisions of the FLSA. The lawsuit quickly landed on the Ninth Circuit's docket after the Oregon District Court dismissed the plaintiff's case.

## **Ninth Circuit Holds that Tip-Pooling Arrangements Can Include Employees Who Do Not Customarily Receive Tips**

Quoting from a 1942 United States Supreme Court opinion, the Ninth Circuit panel began its legal analysis by stating that: "In businesses where tipping is customary, the tips, *in the absence of an explicit contrary understanding*, belong to the recipient. Where, however, [such] an arrangement is made ... , *in the absence of statutory interference, no reason is perceived for its invalidity.*" Despite this, employers in the hospitality industry have struggled for many years over the interplay between tip-pooling arrangements and the ability to take a "tip credit" against the minimum wage. With its decision in *Cumbe*, the Ninth Circuit becomes the first appellate court to weigh in on the ongoing debate about the validity of tip-sharing arrangements in the absence of a tip credit.

### ***The Concept of "Tip Credit"***

The FLSA's definition of *wage* in section 203(m) recognizes that, in some situations, employers of "tipped employees" may include part of the employees' tips to offset the employer's obligation to pay the minimum wage. The FLSA requires employers to pay a tipped employee an amount equal to a cash wage of at least \$2.13 per hour and to ensure that the employee receives an additional amount in tips for every hour worked equal to the federal minimum wage minus the cash wage. The difference between the applicable minimum wage (currently \$7.25 under federal law but higher in many states) and the cash wage is referred to as the "tip credit."

Section 203m of the FLSA provides that the employer may not take a tip credit unless the employer informs employees of the tip-credit provisions set forth in the FLSA and allows the employee to retain all tips earned, unless the employee participates in a tip pool ***with other customarily tipped employees***. Although the FLSA permits tip credits, many Western states within the Ninth Circuit (Alaska, California, Montana, Nevada, Oregon and Washington) do not allow employers to apply tips toward an employee's minimum wage. Other states allow a tip credit against the minimum wage but set the maximum amount higher than under federal regulations (for instance, Arizona caps the amount of tip credit at \$3.00).

### ***Analysis of the Interplay Between Pooling of Tips and Tip Credit***

The plaintiff claimed that section 203(m) required Vita Café to pay her all of the tips that she generated and that Vita Café violated the provision because the restaurant distributed a portion of her tips to other employees (the back-of-the-house staff) who do not "customarily" receive tips. According to the plaintiff, Vita Café was obligated not only to pay servers their minimum wage, but also to allow the servers to keep all of the tips they generated.

In rejecting this argument, the Ninth Circuit first noted that Vita Café never took a tip credit. In fact, because Vita Café's tip pool included non-customarily tipped employees and the plaintiff did not retain all of her tips because of her participation in the pool, it would have been unlawful for Vita Café to take a tip credit under section 203(m). Accordingly, the court concluded that, because Vita Café did not take a tip credit, it was not bound by the constraints of section 203(m) of the FLSA and could fashion its tip-pooling arrangement as it deemed fit, as recognized by the Supreme Court almost 70 years ago.

### ***Arrangement to Distribute Tips to All Employees Is Lawful***

Recognizing the weakness of her first argument, the plaintiff claimed that her forced participation in what she characterized as an "invalid tip pool" was the equivalent of an indirect kick-back to the kitchen staff for the benefit of Vita Café. In doing so, the plaintiff cited to a Department of Labor regulation that requires that an employee's minimum wage be "paid finally and unconditionally or 'free and clear.'" The plaintiff argued that because she was required to pool her tips with others, she did not receive the minimum wage "free and clear" or, in other words, that the portion of her tips that went into the tip pool constituted an improper deduction in violation of the FLSA.

In rejecting the plaintiff's argument that the tip-pooling arrangement was an unlawful kick-back to Vita Café, the court referred back to

its conclusion that section 203(m) does not change the general rule that tips belong to the servers to whom they are given, *unless there exists an agreement to the contrary*. The court concluded that the tip-pooling arrangement was a lawful “agreement to the contrary,” and did not violate the FLSA because Vita Café did not take a tip credit.

## Implications for Employers

This decision is important to many employers within the Ninth Circuit, because they are located in states that prohibit the practice of taking a tip credit against the minimum wage (Alaska, California, Montana, Nevada, Oregon and Washington). It also provides support for employers in other states that wish to implement a system similar to Vita Café’s. One of the advantages of such a system is to redistribute the proceeds of gratuities to all hourly employees, including back-of-the-house employees (positions such as cooks, food preparers and dishwashers). It is common for significant pay disparities to exist between individuals in those positions and those in front-of-the-house positions because the latter share all the proceeds from gratuities generated in the restaurant.

Employers considering implementing a new tip-pool arrangement should keep the following in mind:

- This ruling does not allow employers to implement a tip-pooling agreement that would allow management to share in the tip pool. Federal and several state laws provide severe if not absolute limitations on the ability of management to receive any portion of gratuities intended for employees.
- This ruling does not allow employers to implement a tip-pooling agreement that would allow non-servers to share in the tip pool, in states which prohibit or limit the sharing of tips with non-servers.
- This ruling does not allow employers to require tip-pooling under state laws or regulations whereby such arrangements must be purely voluntary.
- It is sound business practice when implementing a policy requiring redistribution of tips among hourly employees to communicate that policy to employees in writing and to obtain a signed acknowledgment form from all employees.
- To avoid any suggestion that the tip-pooling arrangement is actually a tip credit, ensure that employees are paid the higher of the statutorily required minimum wages under federal or state law. In addition, employers must determine whether any state statutes or regulations govern tip-pooling arrangements regardless of the existence of a tip credit. Employers always must ensure that their tip-pooling arrangements comply with federal and state law.
- Because of extensive litigation in the area of tip pooling and distribution of proceeds from mandatory service charges, it is also sound business practice for employers who use redistribution arrangements (whether of gratuity or of required service charges, or both) to inform guests about the way in which the proceeds are distributed. This disclosure will provide support in any litigation as to the existence and scope of the redistribution arrangement.
- If revising a tip-pool arrangement that involves a tip credit, make sure the arrangement is voluntary, that only non-managerial employees who wait on guests participate in the tip pool and that the arrangement complies with applicable federal and state regulations.
- When revising a tip-pool arrangement to create a system of tip redistribution among all hourly employees, make sure that tips are tracked for inclusion as earnings for year-end tax statements and that all individuals that previously did not receive tips are aware that proceeds from tips are a form of earnings that must be reported to the IRS. If an existing tip-reporting agreement is in place with the IRS, make sure all new tip-pool participants sign the required forms and are coded properly for payroll purposes.

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