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Final Amended FLSA Regulations Make Significant Changes to Tip Credit Processes and Proposed Fluctuating Work Week Rules

By Kimberly Yates and Dan Boatright

On April 5, 2011, the Wage and Hour Division of the U.S. Department of Labor published its final amendments to regulations interpreting the Fair Labor Standards Act of 1938 (FLSA) and the Portal-to-Portal Act of 1947. While most of the changes do little more than comport the regulations to the language of current laws, proposed changes adopted to tip credit regulations, and the decision *not to* adopt proposed amendments concerning fluctuating workweek compensation, are significant and require employers relying on these regulations and pay methods to take immediate action.

Tip Credit Regulation Changes

The amendments to the DOL's tip credit regulations are the first changes to the regulations in 44 years. The DOL's original tip credit regulations were promulgated in 1967, one year after the 1966 FLSA amendment that created the tip credit provision in section 3(m). Although section 3(m) was amended in 1974 and again in 1996, the tip credit regulations remained unchanged.

In addition, the DOL has, over the years, made various position and policy announcements through opinion letters and the DOL's Field Operations Handbook. But courts have not consistently adopted these DOL positions and policies, creating considerable uncertainty in this area.

As discussed below, the recent amendments to the tip credit regulations provide specific guidance pertaining to ownership of employee tips, permissible tip-pooling arrangements, and the required notice to tipped employees concerning an employer's intent to utilize the FLSA's tip credit. But the amendments are also noteworthy for a topic they do not address. In several recent cases, courts have been asked to consider the extent to which a tipped employee may perform ancillary or "non-tipped" duties during the tipped employee's shift. The DOL has filed an amicus brief in at least one of these cases. Despite conflicting rulings in the cases, the recent amendments are silent on this issue.

Ownership of Tips and Tip Pooling

The amended regulations adopt the DOL's previously announced position that tips

are the property of the employee, and that an employer may not take or divert the tips for any purpose other than a valid tip pool. The DOL's position has its origins in the statutory text of the FLSA, which provides that the FLSA's tip credit is available only if (among other conditions) "all tips received by such employee have been retained by the employee, except that this subsection shall not be construed to prohibit the pooling of tips among employees who customarily and regularly receive tips."[1]

There is little or no dispute with the DOL's position on tip ownership where an employer relies on the tip credit to satisfy a portion of its minimum wage obligation. The DOL's position, however, is not limited to such instances. Rather, the DOL contends that the principles of tip ownership extend to situations in which an employer pays full minimum wage, and does not rely on the tip credit.

The DOL's position was directly challenged last year in the case of *Cumbie v. Woody Woo, Inc.*[2] There, Oregon state law did not permit the taking of a tip credit, and the employer paid its waitstaff (servers) full minimum wage. The employer also required servers to contribute a portion of their tips to a pool for the benefit of other employees, including cooks and dishwashers. It is well settled that cooks and dishwashers are not employees who customarily and regularly receive tips, such that the employer's mandatory tip pool would have precluded the employer from taking the FLSA's tip credit. But the tip credit was not at issue, because the employer paid full minimum wage.

Even though servers were paid full minimum wage, a server sued Woody Woo claiming that she could not be required to share her tips with "back of house" kitchen employees. The DOL filed an amicus brief in support of the employee, claiming that employees may not be required to share tips with kitchen employees regardless of whether the employer takes the tip credit.

The Ninth Circuit Court of Appeals rejected the DOL's position, observing that the FLSA merely regulates payment of minimum wage, and that "nothing in the text of the FLSA purports to restrict employee tip-pooling arrangements when no tip credit is taken." According to the Ninth Circuit, ownership of tips is subject to negotiation and agreement between employer and employee, and that agreement may include a provision that the employee has limited, or even no, ownership of tips.

In the preamble to the amended regulations, the DOL acknowledged the Ninth Circuit's decision in *Woody Woo*, but stated "[t]he Department respectfully believes that *Woody Woo* was incorrectly decided." Thus, amended regulation 29 C.F.R. section 531.52 rejects the *Woody Woo* ruling, and states:

> Tips are the property of the employee whether or not the employer has taken a tip credit under section 3(m) of the FLSA. The employer is prohibited from using an employee's tips, whether or not it has taken a tip credit, for any reason other than that which is statutorily permitted in section 3(m) [*i.e.*, a tip pool limited to employees who customarily and regularly receive tips].

The DOL's rejection of *Woody Woo* leaves employers in an unsettled position. Employers within the Ninth Circuit (Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington) should be able to rely on *Woody Woo*, at least with respect to compliance with the FLSA. Employers would be well advised, however, to consider state law limitations on agreements regarding ownership of tips received by employees.

Employers in other states are left in a more difficult position. Courts outside the Ninth Circuit are not bound by *Woody Woo*. Other courts may side with the DOL, especially in light of the amended regulation. Although the amended regulation is not necessarily controlling, courts are required to consider whether it represents a permissible interpretation of the statute. Until the regulation is further tested in courts, the safer approach is to conform tip-pooling practices to the new regulation.

No Limit on "Tip Outs"

Unlike the DOL's refusal to accept the Ninth Circuit's decision in *Woody Woo*, the amended regulations reflect a concession by the DOL in response to court rulings regarding quantitative limits on contributions to tip pools. In prior opinion letters and in the DOL's Field Operations Handbook, the DOL took the position that tipped employees' contributions to a tip pool, or "tip outs," were limited to an amount that was "customary and reasonable," which DOL defined as 15% of tips received or 2% of daily gross sales. Several courts rejected the DOL's interpretation, finding that it was not supported by the plain language of the statute. In the amended regulations, the DOL conceded the point. The amended regulations (29 C.F.R. § 531.54) now provide:

Section 3(m) does not impose a maximum contribution percentage on valid mandatory tip pools, which can only include those employees who customarily and regularly receive tips.

Notice of Tip Credit Provision

Another requirement for the taking of the FLSA tip credit is that the "employee has been informed by the employer of the provisions of [the FLSA's tip credit provision, section 203(m)]."[3] This provision has spawned much litigation regarding the nature and extent of required notice to employees, which is an issue of critical importance to employers because an employer that fails to give the required notice must pay full minimum wage for all hours worked. This can result in significant liability for employers who are deemed to have failed to provide required notice to a large number of tipped employees.

Litigation on this issue has centered on questions such as whether notice must be in writing, and whether the tip credit provision must be explained or merely disclosed. The amended regulation draws from and expands on judicial rulings, and now provides very clear direction in this area.

Pursuant to amended regulations 29 C.F.R. sections 531.54 and 531.59(b), employers must now inform employees, in advance of taking the tip credit, that the employer is using the tip credit of section 203(m), and must include the following information:

- the amount of the cash wage that is to be paid by the employer to the tipped employee
- the amount of tips which will be credited as wages toward the minimum wage requirement (a maximum of $5.12 per hour, not to exceed the value of tips actually received)
- that all tips received by the employee must be retained by the employee except for tips contributed to a valid tip pool limited to employees who customarily and regularly receive tips
- any required tip pool contribution amount
- that the tip credit shall not apply to any employee who has not been informed of the requirements of section 203(m)

Notably, the DOL rejected a position urged by many commenters that employers should be required to provide *written* notice of an employer's intent to use the tip credit. Instead, the DOL adopted the position advocated by Littler Mendelson in its comment to the 2008 proposed rule that verbal notice is sufficient. However, the preamble to the amended regulations suggests that written notice is advisable to document compliance with the regulation.

In light of this amendment, employers should, no later than May 5, 2011, prepare and distribute notice to tipped employees incorporating these elements. Although the notice may be provided verbally, a written notice, signed by each employee, will provide more definitive proof of compliance in cases where the adequacy of notice is challenged.

Tip Credit "Housekeeping" Changes

The amended regulations also clean up various outdated regulatory provisions to bring the regulations in line with 1974 and 1996 amendments to the FLSA. These are necessary, but not particularly newsworthy, changes. For example, as originally enacted, the tip credit applied only to employees receiving at least $20 per month in tips. That threshold was subsequently increased to $30, but the regulations were never amended to reflect the change. The regulations also did not keep pace when the FLSA's formula for the amount of a tipped employee's minimum cash wage changed from 40% of minimum wage to a fixed wage of $2.13 per hour. The amended regulations are now consistent with the statute on these points.

The Abandonment of Proposed Fluctuating Workweek Amendments

Although the DOL did make "technical" changes to its regulations concerning the fluctuating workweek,[4] it decided not to add its proposed language that would have sanctioned pay of bonuses, commissions and other types of compensation in addition to salary to nonexempt employees paid under the fluctuating workweek method.

The fluctuating workweek regulation allows an employer to pay a nonexempt employee who works fluctuating hours from week to week and receives (pursuant to an understanding with the employer) a fixed salary as "straight-time compensation" for all hours worked in a workweek, whether over or under 40, an additional one-half the employee's regular rate of pay for the hours worked in excess of 40 hours in a workweek.

Prior to the 2008 proposed regulation, employers seeking clarification from the DOL received inconsistent advice on the question of whether the payment of bonuses, commissions or other compensation in addition to salary violated the fluctuating workweek regulations. In its 2008 proposed regulations, the DOL recognized that employers sometimes pay employees other types of compensation in addition to salary as incentive compensation or for certain activities (such as working undesirable hours) and that this practice is a "beneficial practice for employees." The proposed 2008 regulation would have made clear that paying such additional compensation did not invalidate the fluctuating workweek method of calculating overtime, so long as the amount of any such additional compensation was included in the determination of the calculation of the regular rate and overtime pay.

In its final regulations, the DOL has now rejected the proposed language and reversed its position on the issue. The DOL agreed with commenters who argued that the receipt of bonuses, commissions or any other compensation in addition to salary is inconsistent with the language in the regulations referencing a "fixed amount as straight time pay for whatever hours [an employee] is called upon to work in a workweek, whether few or many."[5] The DOL expressed a concern that the proposed amendment would permit employers to reduce employees' weekly salaries and shift the bulk of employees' wages to bonus and premium pay, potentially creating a wide disparity in an employee's weekly pay. The DOL found that the fluctuating workweek method of compensation was specifically intended to avoid such disparity and also that the proposed regulation would have been inconsistent with the requirement of a fixed salary payment discussed in the Supreme Court's decision in *Overnight Motor Transportation v. Missel*,[6] the case upon which the fluctuating workweek regulation is based.

More revealing of its disfavor of the fluctuating workweek method, the DOL noted that the use of the fluctuating workweek method has a practical effect of decreasing the regular rate of pay upon which the overtime premium is paid as the number of hours worked in a week increases. The DOL expressed a concern that this diminishing regular rate may also create an incentive for employers to require employees to work long hours. Although the proposed amendment has no effect on this perceived risk, the DOL made clear that its decision not to adopt the language of the proposed regulations was intended to deter "expand[ing] the use of [the fluctuating workweek] method of computing overtime pay beyond the scope of the current regulation."

Given the DOL position articulated in the final rule, employers should adjust their pay practices to eliminate bonuses, commissions or other compensation in addition to salary to employees paid overtime on a fluctuating workweek basis. The DOL's position makes clear that the only payments that should be made to a fluctuating workweek employee are the employee's "fixed salary" and any half-time overtime payments called for by the regulations. However, employers should continue to pay employees additional compensation needed to comply with the minimum wage requirements should an employee's fixed salary fall below the applicable minimum wage due to hours worked.

Employers who prefer to keep bonus, commissions or other types of compensation in their compensation model should stop using the fluctuating workweek method and instead consider alternative forms of compensation that contemplate an employee receiving incentive or bonus payments in addition to normal pay. Employers, of course, can pay nonexempt employees on an hourly basis or by piece rates, day rates, and job rates. In addition, an employer may provide employees with a weekly salary for a pre-determined number of hours each week.[7] Under this method, for example, an employer and employee can agree that the salary compensates the employee for straight time pay for all hours worked up to 50 hours in a workweek. The overtime pay for hours above 40 and up to 50 is then paid at one-half the employee's regular rate. Hours worked above 50 in the workweek are paid at time-and-a-half. Of course, under this exempt salaried pay plan, the regular rate must always be at least minimum wage, and the number of work hours covered by the salary must be reasonably related to the hours employees are actually expected to work. Also, like the fluctuating workweek, this method is not available in states such as California which requires that a nonexempt employee's salary be divided by 40 for purposes of calculating the regular rate and overtime pay.

Reconsideration of Proposed "Meal Credit" Amendments

The DOL also reconsidered proposed changes to regulations concerning meal credits. In the 2008 proposed regulations, the DOL considered including language that would incorporate its "longstanding enforcement position regarding the acceptance of meals furnished as a credit toward the minimum wage." Specifically, the DOL's enforcement position was that an employer can take a meal credit against wages to an employee for a meal provided to the employee, even if the employee did not accept the meal. The DOL's Field Operations Handbook provides that an employer may require an employee to accept a meal provided by the employer as a condition of employment, and may take credit for no more than the actual cost of that meal even if the employees' acceptance is not voluntary.

Influenced by the comments it received in opposition to the proposed regulation, the DOL decided not to incorporate its enforcement policy as an amendment to the regulations, finding that "further study is warranted to assess the extent to which dietary or religious restrictions prevent employees from consuming employer-provided meals and whether adequate time is allowed for the employee to eat." While the DOL did not adopt the proposed amendment, it did not articulate any intent to change its current enforcement position, suggesting only that it "may provide guidance on this issue in the future."

Use of Comp Time by Public Employees

The DOL also declined to adopt proposed regulatory language that would have granted public employers some flexibility in granting compensatory time off to public employees, thus reducing unnecessary overtime costs. In today's atmosphere of public debate regarding the budgetary challenges facing state and local governments, this is perhaps the most surprising change in the final regulations. The 2008 proposal would have changed regulatory language to clarify that public employers where not required to grant comp time on the specific day requested by the employee if doing so would require other employees to work overtime. Instead, public employers would be required to grant the compensatory day off within a reasonable time of the leave requested. The DOL discounted concerns from public employers regarding overtime costs and having sufficient staff to provide services to the public, and instead sided with public employee unions to reject this proposed change. Thus, public employers providing comp time to its employees much grant comp time on the specific date requested, even if doing so results in additional overtime costs.

Automobile Dealership Exemption

Finally, the DOL rejected proposed changes that would have clarified that service managers, writers, advisors and salesmen are exempt under section 13(b)(10)(A) of the FLSA. Section 13(b)(10)(A) provides an exemption from the FLSA's overtime requirements for "any salesman, partsman, or mechanic primarily engaged in selling or servicing automobiles, trucks, or farm implements, if he is employed by a nonmanufacturing establishment primarily engaged in the business of selling such vehicles or implements to ultimate purchasers." In 2008, the DOL proposed language to clarify that this exemption applied to employees of automobile dealerships involved in selling and working under service contracts. In the final regulations, the DOL rejected the proposed language stating that the exemption only applies to employees who sell or work on cars – not service contracts. However, an overtime exemption may still be available for such employees paid on a commission basis under section 7(i) of the FLSA.

Other "Technical" Changes to the FLSA Regulations

The remaining changes to the FLSA regulations are relatively unremarkable and do little more than bring the language of the regulations in line with language contained in legislation enacted since the regulations were originally promulgated. These changes include:

- Incorporation of language from the Employee Commuting Flexibility Act of 1996 (the law which provides an employee's use of an employer's vehicle for normal home-to-work commuting, and any activities incidental to the use of the vehicle to commute, is not compensable work) into 29 C.F.R. sections 785.9, 785.34, 785.50, and 790.3.
- Revising regulations concerning the Youth Opportunity Wage (a temporary sub-minimum wage paid to workers under age 20) to cite provisions of the Small Business Job Protection Act of 1996.

- Modifying regulations concerning agricultural workers on water storage/irrigation projects to be consistent with the 1997 Departments of Labor, Health and Human Services, Education, and Related Agencies Appropriations Act.
- Revising regulations pertaining to volunteers at private non-profit food banks to include exemptions included in the Amy Somers Volunteers at Food Banks Act of 1998.
- Changing the regulatory definition of an "employee . . . in fire protection activities" to be consistent with a 1999 amendment to the FLSA that defines the term.
- Revising overtime regulations concerning calculations of the "regular rate" of pay to include provisions from the Worker Economic Opportunity Act of 2000 that exclude the value of stock options from the regular rate calculation.
- Addition of language to regulations pertaining to the exempt status of salesmen, partsmen, or mechanics of automobiles, trucks, or farm implements that reflects a 1974 amendment to section 13(b)(10) of the FLSA.
- Updating the regulations with "technical amendments" to reflect the increase in the amount of the minimum wage and other outdated threshold amounts, and eliminating outdated references in the regulations to former minimum wage rates.

Although these "technical amendments" are an important update, in some instances, the current regulations called for more than mere modernization. For instance, while the DOL amended its regulations to make them consistent with the language of the Employee Commuting Flexibility Act, it declined to clarify or provide examples of what constitutes "incidental activities" that are the subject of the Act, leaving the question of what constitutes an "incidental activity" for which an employee need not be compensated an issue for employers to contemplate and the courts to decide.

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[1] 29 U.S.C. § 203(m).

[2] 596 F.3d 577 (9th Cir. 2010).

[3] 29 U.S.C. § 203(m).

[4] 29 C.F.R. § 778.114.

[5] 29 C.F.R. § 778.114.

[6] 316 U.S. 572 (1942).

[7] *See* 29 C.F.R. §§ 778.113, 778.325.