Legal Alert: New York's Highest Court Addresses Mandatory Service Charges

2/29/2008

According to New York state's highest court, under the state's wage and hour law, an employer cannot withhold from its employees any portion of a mandatory service charge that is added to a customer's bill unless the employer makes it clear to the customer that it is retaining some or all of the charge. *See Samiento v. World Yacht, Inc. et al.*, No. 17 (N.Y. Ct. App. Feb. 14, 2008). It has been a longstanding practice in the hospitality industry for some employers to impose a service charge on their customers in connection with private parties, banquets, special events and other similar circumstances. A number of lower state courts have held that such charges, where mandatory, are not gratuities that must be distributed to employees; instead, the employer may retain all or part of the service charge. However, overruling these decisions, the Court of Appeals held that under New York law, service charges are considered gratuities and must be distributed to employees *unless customers are notified otherwise*. The issue arose when employees working banquets on a New York-based cruise ship sued their employer because the employer retained most or all of the mandatory service charge it added to its ticket prices. The employees also asserted that the employer told inquiring patrons that the service charge was a gratuity, which discouraged them from leaving tips for the service staff. New York Labor Law § 196-d reads in part:

Gratuities. No employer or his agent or an officer or agent of any corporation, or any other person shall demand or accept, directly or indirectly, any part of the gratuities, received by an employee, or retain any part of a gratuity or any charge purported to be a gratuity for an employee…. The last sentence of the law states that: Nothing in this subdivision shall be construed as affecting practices in connection with banquets and other special functions where a fixed percentage of the patron's bill is added for gratuities which are distributed to employees, nor to the sharing of tips by a waiter with a busboy or similar employee. World Yacht employees claimed their employer violated § 196-d by informing its banquet patrons, when asked, that the service charge was a tip that went to the servers. Both the New York State Department of Labor (NYSDOL) and the New York Attorney General supported the employees' interpretation of the law. The employer, however, defended its practice of retaining service charges by arguing that under § 196-d, a tip must be voluntary to constitute a gratuity. The employer argued that service charges were not contemplated as falling within the phrase "any charge purported to be a gratuity" in §196-d, citing the section's last sentence, commonly referred to as the "banquet exception." The Court disagreed and held that the language "any charge purported to be a gratuity" should be liberally construed. The Court found that the legislative history did not support the employer's banquet exception defense, but instead established that

mandatory service charges are included within the definition when the charge is represented as a gratuity that goes to the employer's wait staff. The Court explained that the New York State Hotel & Motel Association requested the inclusion of the banquet exception to ensure the industry could continue its tradition of adding a service charge and then distributing it to all service employees. The Court held "the standard under which a mandatory charge or fee is purported to be a gratuity should be weighted against the expectation of the reasonable customer." The Court pointed to an opinion letter submitted by the NYSDOL as support for its decision. The NYSDOL's letter stated that "[i]f the employer's agents lead the patron who purchases a banquet or other special function to believe that the contract price includes a fixed percentage as a gratuity, then that percentage of the contract price must be paid in its entirety to the waiter, busboys and 'similar employees' who work at the function, even if the contract makes no reference to such a gratuity." The Court also noted a problem with the employer's tax treatment of its service charge. While gratuities are not considered part of an employer's gross revenues for taxation purposes, service charges are. The employer in this case was not treating the service charge as part of its gross revenues. In remanding the case, the Court asked the lower court to consider whether the employer was in compliance with the law. **Employers' Bottom Line:** Hospitality industry employers should review their practices with respect to service charges and gratuities to ensure that they are in compliance with all applicable laws. For instance, employers assessing service charges should ensure that they clearly communicate to patrons that some or all of the service charge is not distributed to employees, if indeed that is the case. Other areas of inquiry should include a review of how service charges are treated for tax purposes, as well as whether any such service charges received by employees are factored into the employees' regular rate of pay for overtime purposes, if applicable. Employers should also be aware that mandatory service charges are not considered gratuities for purposes of the "tip credit" established under the federal Fair Labor Standards Act. If you have any questions regarding this decision or other wage and hour issues, please contact the Ford & Harrison attorney with whom you usually work or the authors of this Legal Alert, Philip Davidoff, pdavidoff@fordharrison.com, 212-453-5915 or Alyson Bruns, abruns@fordharrison.com, 212-453-5907, attorneys in our New York City office.